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ESTATE TAX ISSUES—1983

HEARING

BEFORE THE

SUBCOMMITTEE ON
ESTATE AND GIFT TAXATION

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

S. 309, S. 310, S. 953, S. 1180, S. 1210, S. 1250, S. 1251, S. 1252, and S. Res. 126

JUNE 27, 1983

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CONTENTS

ADMINISTRATION WITNESSES

Page
Woodward, Robert G., Acting Tax Legislative Counsel, Department of the Treasury 55

PUBLIC WITNESSES

Abbott, George W., Esq 406
Ad Hoc Coalition on Estate Taxation, G. Robin Swift, Jr., president, Swift Lumber, Inc 121
American Bankers Association, Austin N. Wentworth II, accompanied by J. Stoddard Hayes 321
American Bar Association, Malcolm A. Moore, chairman, Section of Real Property, Probate, and Trust Law 267
American Bar Association, Edward N. Delaney, chairman-elect, Section of Taxation accompanied by John Jones 240
American College of Probate Counsel, John A. Wallace, chairman, Estate and Gift Committee 328
American Farm Bureau Federation, James Lockett, president, Oklahoma Farm Bureau 143
Associated General Contractors of America, Billy R. Carter, chairman, Tax and Fiscal Affairs Committee 251
Baetz, W. Timothy, Esq., on behalf of the Illinois State Bar Association 305
Barkley, Robert, Yuma, Ariz 258
Bellatti, Robert M., Esq., on behalf of the Illinois State Bar Association 370
Carter, Billy R., chairman, Tax and Fiscal Affairs Committee, Associated General Contractors of America 251
Delaney, Edward N., chairman-elect, Section of Taxation, American Bar Association, accompanied by John Jones 240
Fitch, John H., Jr., vice president, Government relations, National Association of Wholesaler-Distributors 202
Forest Industries Committee on Timber Valuation and Taxation, Eley C. Frazer III, president, F&W Forestry Services, Inc 177
Franasiak, David E., manager, Tax Policy Center, U.S. Chamber of Commerce 171
Frazer, Eley C., III, president, F&W Forestry Services, Inc., on behalf of the Forest Industries Committee on Timber Valuation and Taxation 177
Harper, James, vice chairman, Tax Committee, National Cattlemen's Association, accompanied by Alvin J. Geske, Esq. and J. Burton Eller, Jr 150
Hughes, Robert J., Jr., Esq., chairman, Trusts and Estates Law Section, New York State Bar Association 345
Hughes, Vester T., Jr., Esq., partner, Hughes & Hill 297
Illinois State Bar Association, Robert M. Bellatti, Esq 370
Illinois State Bar Association, Timothy W. Baetz, Esq 305
Iskrant, John D., Esq 362
Lockett, James, president, Oklahoma Farm Bureau on behalf of the American Farm Bureau Federation 143
Moore, Malcolm A., chairman, Section of Real Property, Probate, and Trust Law, American Bar Association 267
National Association of Wholesale-Distributors, John H. Fitch Jr., vice president, Government relations 202
National Cattlemen's Association, James Harper, vice chairman, Tax Committee, accompamied by Alvin J. Geske, Esq., and J. Burton Eller, Jr 150

	Page
National Family Business Council, Suzanne Nordblom, chairman, Government Affairs Committee, accompanied by Robert Statham	223
National Small Business Association, Stevan A. Wolf, chairman, legislative and policy committee	231
National Tax Equality Association, Ray M. Stroupe, president	135
New York State Bar Association, Robert J. Hughes, Jr., chairman, Trusts and Estates Law Section	345
Nordblom, Suzanne, president, Nordblom & Associates, Inc., on behalf of the National Family Business Council, accompanied by Robert Statham	223
Redfield Land Co., Gerald C. Smith, representative	381
Seidman, P. K., Esq., accompanied by Sheldon S. Cohen, Esq	350
Smith, Gerald C., representative, Redfield Land Co.	381
Springfield Marine Bank, Robert A. Warden, Esq	364
Stroupe, Ray M., president, National Tax Equality Association	135
Swift, G. Robin, Jr., president, Swift Lumber, Inc., on behalf of the Ad Hoc Coalition on Estate Taxation	121
U.S. Chamber of Commerce, David E. Franasiak, manager, Tax Policy Center.	171
Wallace, John A., chairman, Estate and Gift Tax Committee, American College of Probate Counsel	328
Warden, Robert, A., Esq., on behalf of the Springfield Marine Bank	364
Wentworth, Austin N., II, vice president, First National Bank, Boston, Mass., accompanied by J. Stoddard Hayes, vice president, Wilmington Trust Co., Wilmington, Del., on behalf of the American Bankers Association	321
Wolf, Stevan A., chairman, Legislative and Policy Committee, National Small Business Association	231

ADDITIONAL INFORMATION

Committee press release	1
Description of bills S. 309, S. 310, S. 953, S. 1180, S. 1210, S. 1250, S. 1251, S. 1252, and S. Res. 126 by the Joint Committee on Taxation	3
Opening statements of:	
Senator Steven Symms	53
Senator Charles Grassley	53
Prepared statement of:	
Robert G. Woodward	68
Senator Malcolm Wallop	120
G. Robin Swift, Jr	124
Ray M. Stroupe	137
James L. Lockett	144
James Harper	152
David E. Franasiak	172
Eley C. Frazer III	179
John H. Fitch, Jr	204
Suzanne Nordblom	225
Stevan A. Wolf	234
Edward N. Delaney	242
Billy R. Carter	253
Robert K. Barkley	260
Malcolm A. Moore	272
Vester T. Hughes, Jr	301
W. Timothy Baetz	307
Austin N. Wentworth II	323
John A. Wallace	332
Robert J. Hughes, Jr	348
P. K. Seidman	352
Robert A. Warden	366
Illinois State Bar Association	372
Gerald C. Smith	383
Senator Paul Laxalt	407

COMMUNICATIONS

Association of the Bar of the City of New York, Committee on Trusts, Estates, and Surrogates' Courts	412
Robert Bracken, attorney at law	428
California Continuing Education of the Bar	429
Chicago Bar Association	439

Page
Corporate Fiduciaries Association of Illinois 443
Holstien Association 454
Independent Petroleum Association of America 456
Institute for Research on the Economics of Taxation 459
National Association of Wheat Growers 468
National Farmers Union 471
National Federation of Independent Business 478
National Forest Products Association 482
National Milk Producers Federation 484
Roberts & Holland 488
Schnader, Harrison, Segal & Lewis 504
Shea & Gould 509
Tax Law Action Group 513
Tipton & Tipton 522
Worthy, K. Martin 524
Young, Kaplan, Ziegler & Zisselman 533

ESTATE TAX ISSUES—1983

MONDAY, JUNE 27, 1983

U.S. SENATE,
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION,
COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:35 a.m. in room SD-215, Dirksen Senate Office Building, the Honorable Steven D. Symms (chairman of the subcommittee) presiding.

Present: Senators Symms, Boren, and Bentsen.

[The committee press release announcing this hearing; bills S. 309, S. 310, S. 953, S. 1180, S. 1210, S. 1250, S. 1251, S. 1252, and S. Res. 126; the description by the Joint Committee on Taxation; and the opening statements of Senators Symms and Grassley follow:]

[Press Release]

FINANCE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION SETS HEARING ON ESTATE TAX ISSUES

Senator Steven Symms, Chairman of the Subcommittee on Estate and Gift Taxation of the Senate Committee on Finance, announced today that the subcommittee will hold a hearing to discuss estate tax issues on Monday, June 27, 1983.

The hearing will begin at 9:00 a.m. in Room SD-215 of the Dirksen Senate Office Building.

In announcing the hearing, Senator Symms indicated that the following proposals would be discussed:

S. 953.—Introduced by Senator Laxalt. The bill would amend the Internal Revenue Code of 1954 to permit elections under Section 2032A to be made on amended returns.

S. 1180.—Introduced by Senator Durenberger, Boren, and Wallop. The bill would amend the Internal Revenue Code of 1954 to provide transitional rules for estate and gift tax treatment of disclaimers of property interests created by transfers before November 15, 1983.

S. 1210.—Introduced by Senators Baker and Sasser. The bill would amend the Internal Revenue Code of 1954 to provide that the election to use the alternate valuation date for purposes of the estate tax may not be made under certain circumstances and to permit an election to be made on a return that is filed late.

S. 1250.—Introduced by Senators Symms, Boren, and others. The bill would amend the Internal Revenue Code of 1954 to repeal the estate and gift taxes.

S. 1251.—Introduced by Senators Symms, Wallop, Boren, Grassley, Bentsen, and others. The bill would amend the Internal Revenue Code of 1954 to treat certain interests as closely held businesses for estate tax purposes, to prevent the acceleration of estate tax installment payments in certain situations, and for other purposes.

S. 1252.—Introduced by Senators Symms, Armstrong, Boren, Grassley, Wallop, Pryor, and others. The bill would amend the Internal Revenue Code of 1954 to repeal the generation skipping transfer tax. The subcommittee would also appreciate comments on the Administration's Spring 1983 proposal to reform the generation skipping transfer tax.

S. Res. 126.—Introduced by Senators Wallop, Boren, Symms, Durenberger, Grassley, Bentsen, Dole, Roth, Baucus, and others. The resolution expresses the sense of the Senate that the changes in the Federal estate tax laws made by the Economic Recovery Tax Act of 1981 should not be modified.

S. 309.—Introduced by Senator Laxalt. The bill would provide relief for the estate of Nell J. Redfield.

S. 310.—Introduced by Senator Laxalt. The bill would provide relief for the estate of Elizabeth Schultz Rabe.

The subcommittee would also appreciate comments and suggestions on estate tax reform measures that should be considered for enactment such as further rate reduction, further modification of the rules governing special use valuation, and a possible change to eliminate the problems with integrating the State death provisions with the unlimited marital deduction to insure that the results envisioned by the unlimited marital deduction will be achieved.

DESCRIPTION OF GIFT AND ESTATE TAX MATTERS, INCLUDING S. 309, S. 310, S. 953, S. 1180, S. 1210, S. 1250, S. 1251, S. 1252, S. RES. 126, AND CERTAIN OTHER MATTERS

Scheduled for a Hearing

before the

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

of the

COMMITTEE ON FINANCE

on

JUNE 27, 1983

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Subcommittee on Estate and Gift Taxation of the Senate Committee on Finance has scheduled a hearing on June 27, 1983, on the following bills and resolution: S. 309 (relating to special estate tax credit for the estate of Nell J. Redfield), introduced by Senators Laxalt and Hecht; S. 310 (relating to special estate tax credit for the estate of Elizabeth Schultz Rabe), introduced by Senators Laxalt and Hecht; S. 953 (relating to permission to elect current use valuation on amended returns), introduced by Senator Laxalt; S. 1180 (relating to the gift and estate tax treatment of disclaimers of property created by transfers before November 15, 1958), introduced by Senators Durenberger, Boren, and Wallop; S. 1210 (relating to permission to elect alternate valuation date on a late return), introduced by Senators Baker and Sasser; S. 1250 (relating to the repeal of the gift, estate, and generation-skipping transfer taxes), introduced by Senators Symms, Boren, and others; S. 1251 (relating to amendments to the provision permitting the installment payment of estate taxes attributable to interests in certain closely held businesses), introduced by Senators Symms, Wallop, Boren, Grassley, Bentsen, and others; S. 1252 (relating to the repeal of the generation-skipping transfer tax), introduced by Senators Symms, Armstrong, Boren, Grassley, Wallop, Pryor, and others); and S. Res. 126 (relating to the sense of the Senate that certain scheduled modifications in the gift and estate taxes not be altered), introduced by Senators Wallop, Boren, Symms, Durenberger, Grassley, Bentsen, Dole, Roth, Baucus, and others. In addition, the Subcommittee has invited comments on (1) the Treasury Department proposal on the generation-skipping transfer tax; (2) modifications to the gift, estate, and generation-skipping transfer tax rates, (3) the relationship between the Federal unlimited marital deduction and State death taxes, and (4) modification of certain of the rules relating to current use valuation.

The first part of this pamphlet is a summary of the bills, resolution, and other matters which are the subject matter of the hearing. The second part contains background information concerning Federal gift, estate, and generation-skipping transfer taxes, including an overview of present law, a summary of the legislative history of those taxes, and statistical information concerning the burdens and revenues from those taxes. The third part is a more detailed description of the bills and resolution which are the subject of the hearing, including a description of present law, issues, explanation of provisions, and estimated revenue effects. The fourth part is a description of the other matters—which comments have been invited.

I. SUMMARY

A. Present Law

Under present law, a gift tax is imposed on lifetime transfers and an estate tax is imposed on deathtime transfers. In addition, a generation-skipping transfer tax is imposed on certain transfers which benefit more than one generation but which would not be subject to gift or estate tax upon the termination of the interests of intervening younger generations.

Under the Tax Reform Act of 1976, the gift and estate taxes were unified so that a single progressive rate schedule is applied to cumulative lifetime and deathtime transfers. Under the unified rate schedule, as amended by the Economic Recovery Tax Act of 1981 (ERTA), the rates range from 18 percent on the first $10,000 of taxable transfers to 60 percent on taxable transfers in excess of $3.5 million. The maximum rate is scheduled to decline in annual increments of 5 percent, to 50 percent on transfers in excess of $2.5 million. The 50 percent maximum rate will be effective on January 1, 1985.

A unified credit is allowed against an individual's gift and estate tax liabilities. With the present unified credit of $79,300 and the existing rate schedule, there is no gift or estate tax on transfers of up to $275,000. The unified credit is scheduled to increase annually through 1987, at which time no gift or estate taxes will be imposed on transfers of up to $600,000. In addition, a limited estate tax credit is allowed for State death taxes.

Present law allows an annual exclusion, for gift tax purposes, of $10,000 per donee. In addition, in the case of a qualified disclaimer by a donee or heir, the donee or heir is not deemed to have made a gift.

An unlimited deduction is allowed in computing the gift and estate taxes for certain transfers to spouses (i.e., the marital deduction). An unlimited deduction is allowed for gift and estate tax purposes for certain transfers for charitable, etc., purposes (i.e., the charitable deduction).

The estate tax provisions also allow certain real property used in the trade or business of farming or in other closely held trades or businesses to be valued at its current use value rather than its highest and best use value. The maximum reduction in the value of the real property by reason of the special valuation provision is $750,000. The estate tax benefits of the special valuation provision are recaptured in whole or in part if the heir disposes of the land or ceases to use it as a farm or in the closely held business within 10 years of the decedent's death.

Present law also allows the installment payment of estate taxes attributable to closely held businesses. Under this provision, payments may be made over a 14-year period and there is a special 4-

percent interest rate on the estate tax attributable to the first $1 million of interests in closely held businesses.

B. Bills, Resolution, and Other Matters

1. S. 309

S. 309 would provide a special estate tax credit to the Estate of Nell J. Redfield, if certain forest land included in that estate is transferred to the National Forest Service.

2. S. 310

S. 310 would provide a special estate tax credit to the Estate of Elizabeth Schultz Rabe, if certain forest land included in that estate is transferred to the National Forest Service.

3. S. 953

S. 953 would permit current use valuation elections to be made on amended estate tax returns, effective for estates of individuals dying after 1976.

4. S. 1180

S. 1180 would permit disclaimers of certain interests transferred before November 15, 1958, to be made after expiration of the time otherwise provided for disclaiming.

5. S. 1210

S. 1210 would permit the estate tax alternate valuation date to be elected on late returns in certain cases.

6. S. 1250

S. 1250 would repeal the gift, estate, and generation-skipping transfer taxes, effective with respect to individuals dying, and gifts made, after 1982.

7. S. 1251

S. 1251 would expand the types of assets that are eligible for special treatment under the estate tax installment payment provision as an interest in a closely held business, would liberalize the rules under which unpaid installments of tax and interest are accelerated, would provide a new interest rate on deferred tax and new rules on the deductibility of that interest, and would provide for judicial review of Internal Revenue Service determinations under that provision.

8. S. 1252

S. 1252 would repeal the generation-skipping transfer tax, effective for transfers after June 11, 1976.

9. S. Res. 126

S. Res. 126 would express the sense of the Senate that certain gift and estate tax reductions scheduled to become effective after 1983 should not be modified as part of any tax increase this year.

10. Other matters

Treasury Department proposal on generation-skipping transfer tax.—The Treasury Department proposal would modify the present generation-skipping transfer tax provisions by providing a flat-rate tax generally imposed on generation-skipping transfers in excess of $1 million and making other simplifying changes to the tax.

Relationship of Federal unlimited marital deduction to State death taxes.—Under present law, State death taxes may exceed the available Federal credit for those taxes and thereby result in imposition of a Federal estate tax where no such tax otherwise would be imposed due to the Federal unlimited marital deduction.

Modification of current use valuation rules.—The maximum reduction in value that can be achieved under the current use valuation provision is limited to $750,000; special rules are also provided for current use valuation of standing timber (Other farm crops may not be specially valued.).

II. BACKGROUND INFORMATION

A. Overview of Present Law

Under present law, a gift tax is imposed on lifetime transfers and an estate tax is imposed on deathtime transfers. Under the Tax Reform Act of 1976, the gift and estate taxes were unified so that a single progressive rate schedule is applied to cumulative lifetime and deathtime transfers.

1. Rates, unified credit, and computation of tax

Under the unified gift and estate tax rate schedule, rates range from 18 percent on the first $10,000 in taxable transfers to 60 percent on taxable transfers in excess of $3.5 million. The maximum tax rate is scheduled to decline to 55 percent on transfers in excess of $3 million, effective on January 1, 1984, and to 50 percent on transfers in excess of $2.5 million, effective on January 1, 1985.[1]

The amount of gift tax payable (for any calendar year) is determined by applying the unified rate schedule to cumulative lifetime taxable transfers and then subtracting the taxes payable on the lifetime transfers made for past taxable periods. This amount then is reduced by any available unified credit (and certain other credits) to determine the amount of gift tax liability for that period.

The amount of estate tax generally is determined by applying the unified rate schedule to the aggregate cumulative post-1976 lifetime and deathtime transfers and then subtracting the post-1976 gift taxes payable on the lifetime transfers. (In essence, deathtime transfers are treated as the last taxable gift by the decedent.) This amount then is reduced by any remaining unified credit and by certain other credits (discussed below) in determining the amount of estate tax liability.

The unified credit presently is $79,300.[2] With a unified credit of $79,300 and the existing rate schedule, there is no gift or estate tax on transfers of up to $275,000.[3] The unified credit is scheduled to increase to $96,300 (effective on January 1, 1984), to $121,800 (effective on January 1, 1985), to $155,800 (effective on January 1, 1986) and to $192,800 (effective on January 1, 1987). The amounts that can be transferred free of tax with each of these credits amounts are $325,000, $400,000, $500,000 and $600,000, respectively.

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[1] Prior to the Tax Reform Act of 1976, there were separate rate schedules for the gift and estate taxes. The gift tax rates were approximately three-fourths of the estate tax rates. The Tax Reform Act of 1976 combined the separate rate schedules into a unified transfer tax rate schedule.

[2] Prior to the enactment of the Tax Reform Act of 1976, there was a $30,000 lifetime exemption for gift tax purposes and a $60,000 exemption for estate tax purposes. The Tax Reform Act of 1976 converted the gift and estate tax exemptions into a unified credit. With a unified credit, the gift or estate tax first is computed without any exemption and then the unified credit is subtracted to determine the gift or estate tax liability. The $47,000 unified credit established by the Tax Reform Act of 1976 was phased in over a five-year period as follows: $30,000 for 1977, $34,000 for 1978, $38,000 for 1979, $42,500 for 1980, and $47,000 for 1981.

[3] Note that the effect of the unified credit is, in essence, to reduce the rates of tax on the first $275,000 of transfers to zero and to subject transfers in excess of that amounts to tax at the rates based upon cumulative transfers including that amount. Thus, the lowest rate at which tax liability is actually incurred under the gift and estate tax presently is 34 percent.

2. Transfers subject to tax: taxable gifts and the gross estate

Gift tax

The gift tax is imposed on any transfer of property by gift whether made directly or indirectly and whether made in trust or otherwise (Code sec. 2501). The amount of the taxable gift is determined by the fair market value of the property on the date of gift. In addition, the exercise or the failure to exercise certain powers of appointment are also subject to the gift tax.

Present law provides an annual exclusion of $10,000 ($20,000 where the nondonor spouse consents to split the gift) of transfers of present interests in property for each donee. In addition, certain transfers of interests in qualified pension plans are excluded from the tax and unlimited transfers between spouses are permitted without imposition of a gift tax.

Estate tax

Under present law, all property included in the "gross estate" of the decedent is subject to tax (sec. 2001). The gross estate generally includes the value of all property in which a decedent has an interest at his or her death (sec. 2031).[4] The amount included in the gross estate is generally the fair market value of the property at the date of the decedent's death, unless the executor elects to value all property in the gross estate at the alternate valuation date (which is six months after the date of the decedent's death).[5]

In addition, the gross estate includes the value of certain properties not owned by the decedent at the time of his or her death if certain conditions are met. These conditions include, generally, transfers for less than adequate and full consideration if (1) the decedent retained the beneficial enjoyment of the property during his or her life (sec. 2036) or the power to alter, amend, revoke, or terminate a previous lifetime transfer (sec. 2038), (2) the property was transferred within three years of death (under certain limited circumstances) (sec. 2035), (3) the property was previously transferred during the decedent's lifetime but the transfer takes effect at the death of the decedent (sec. 2037). Also, interests in certain annuities (other than certain interests in qualified retirement plans) are excluded from the decedent's estate to the extent their value does not exceed $100,000 (sec. 2039). In addition, the gross estate includes the value of property subject to certain general powers of appointment possessed by the decedent (sec. 2041), and the proceeds of life insurance on the decedent if the insurance proceeds are receivable by the executor of the decedent's estate or the decedent possessed an incident of ownership in the policy (sec. 2042).

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[4] Special rules (discussed below in Part II.3.) are provided for jointly held property.

[5] See below (Part II.4.) for a discussion of the special method permitted for the valuation of real estate used in certain farming and other closely held businesses under Code section 2032A.

3. Jointly held property

The present estate tax provisions contain several special rules governing the treatment of jointly held property for estate tax purposes. These rules apply to forms of ownership where there is a right of survivorship upon the death of one of the joint tenants. They do not apply to community property or property owned as tenants in common.

In general, under these rules, the gross estate includes the value of property held jointly at the time of the decedent's death by the decedent and another person or persons with the right of survivorship, except that portion of the property that was acquired by the other joint owner, or owners, for adequate and full consideration in money or money's worth, or by bequest or gift from a third party. The decedent's estate has the burden of proving that the other joint owner, or owners, acquired their interests for consideration, or by bequest or gift. Consideration furnished by the surviving joint owner, or owners, does not include money or property shown to have been acquired from the decedent for less than a full and adequate consideration in money or money's worth.

The Economic Recovery Tax Act of 1981 (ERTA) provided special rules for certain qualified interests held in joint tenancy by the decedent and his or her spouse. If a decedent owns a qualified joint interest, one-half of the value of such interest is included in the gross estate of the decedent, valued as of the date of the decedent's death (or alternate valuation date), regardless of which joint tenant furnished the consideration. An interest is a qualified joint interest only if the interest was created by the decedent or his or her spouse, or both, and there are no joint tenants other than the decedent and the spouse.

4. Current use valuation

If certain requirements are met, present law allows real property used in family farms and other closely held businesses to be included in a decedent's gross estate at the property's current use value, rather than its full fair market value, provided that the gross estate may not be reduced more than, $750,000 (sec. 2032A).

An estate may qualify for current use valuation if: (1) the decedent was a citizen or resident of the United States at the time of his or her death; (2) the value of the farm or closely held business assets in the decedent's estate, including both real and personal property (but reduced by secured debts attributable to the real and personal property), is at least 50 percent of the decedent's gross estate (reduced by secured debts); (3) at least 25 percent of the adjusted value of the gross estate is qualified farm or closely held business real property; [6] (4) the real property qualifying for current use valuation passes to a qualified heir; [7] (5) such real property has been owned by the decedent or a member of his or her family and used or held for use as a farm or closely held business ("a qualified use") for 5 of the last 8 years prior to the decedent's death; and (6) there has been material participation in the operation of the farm or closely held business by the decedent or a member of his or her family for periods aggregating 5 years out of the 8 years immediately preceding the earliest of the decedent's death or continuous disability or retirement lasting until that date (secs. 2032A (a) and (b)).[8]

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[6] For purposes of the 50-percent and 25-percent tests, the value of property is determined without regard to its current use value.

[7] The term "qualified heir" means a member of the decedent's family, including his or her spouse, lineal descendants, parents, and their descendants.

If, within 10 years after the death of the decedent (but before the death of the qualified heir), the specially valued real property is disposed of to nonfamily members or ceases to be used for the farming or other closely held business purposes based upon which it was valued, all or a portion of the Federal estate tax benefits obtained from the reduced valuation will be recaptured by means of a special "additional estate tax" imposed on the qualified heir.

5. Allowable deductions

Charitable deduction

Present law allows a deduction for certain amounts transferred for charitable, etc., purposes in computing both the amount of taxable gifts and the taxable estate. The deduction is allowed for amounts transferred to the United States or any State or local government, to certain organizations organized and operated exclusively for charitable, etc., purposes, and to certain organizations of war veterans. Where the charitable transfer is an interest that is less than the donor/decedent's entire interest in the transferred property (e.g., a remainder interest), present law requires that the gift or bequest take certain specified forms in order to be deductible.

Marital deduction

Both the gift tax and the estate tax allow an unlimited deduction for certain amounts transferred from one spouse to another spouse. The Economic Recovery Tax Act of 1981 repealed the former quantative limits on the marital deduction so that no gift or estate tax is imposed on transfers between spouses. This provision was effective on January 1, 1982. ERTA further made certain terminable interests (commonly referred to as "QTIP" interests) eligible for the marital deduction and provided that those interests are includible in the estate of the surviving spouse. Terminable interests generally are not deductible and are created when an interest in property passes to the spouse and another interest in the same property passes to some other person for less than adequate and full consideration. For example, an income interest to the spouse where the remainder interest is transferred to a third party is a terminable interest.

Under the marital deduction as first adopted in 1948, a donor was allowed a marital deduction for gift tax purposes equal to one-half of the property transferred to his or her spouse. For estate tax purposes, the estate was allowed a deduction for property transferred to the spouse of the decedent up to one-half of the adjusted gross estate.[9] The adoption of the marital deduction allowed one spouse to transfer one-half of his or her wealth to the other spouse free of gift or estate taxes. Thus, residents of common law States could achieve roughly the same tax treatment as residents of community law States.[10]

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[8] In the case of qualifying real property where the material participation requirement is satisfied, the real property which qualifies for current use valuation includes the farmhouse, or other residential buildings, and related improvements located on qualifying real property if such buildings are occupied on a regular basis by the owner or lessee of the real property (or by employees of the owner or lessee) for the purpose of operating or maintaining the real property or the business conducted on the property. Qualified real property also includes roads, buildings, and other structures and improvements functionally related to the qualified use.

Expenses, indebtedness, taxes, and losses

In addition to the charitable and marital deductions, estate tax deductions are allowed for certain administrative expenses of the estate, certain indebtedness of the decedent, and certain taxes other than estate, succession, legacy, or inheritance taxes (sec. 2053). A deduction also is allowed for casualty losses incurred by the decedent's estate (sec. 2054).

6. Credits against tax

In addition to the unified credit, several credits are allowed to estates which directly reduce the amount of the estate tax. Two of the most important are the credit for tax on prior transfers and the credit for State death taxes.

Credit for tax on prior transfers

Where property includible in the decedent's gross estate has recently been subject to a previous Federal estate tax, a credit is allowed for all or a portion of that previous Federal estate tax. The amount of the credit is reduced the longer the period of time between imposition of the previous Federal estate tax and the death of the decedent. After 10 years, there is no credit (sec. 2013).

State death tax credit

A limited credit is allowed against the Federal estate tax for the amount of any estate, inheritance, legacy, or succession taxes actually paid to any State or the District of Columbia on account of any property included in the gross estate (sec. 2011). The amount of the credit varies with the size of the taxable estate and ranges from no credit on small estates to 16 percent on estates exceeding approximately $10 million.[11]

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[9] The Tax Reform Act of 1976 modified the marital deduction for both gift and estate tax purposes to allow a full marital deduction for certain limited amounts of property passing between spouses.

[10] The original purpose of the marital deduction was generally to equate the tax treatment of property ownership in common law States with the tax treatment in community law States. In a community law State, one-half of all community property generally is owned for tax purposes by each spouse even though only one spouse generated the income to acquire the property. In a common law State, the property is generally considered owned for tax purposes by the spouse who generated the income to acquire the property. Because a progressive rate structure taxes one large accumulation of wealth more heavily than two smaller accumulations, residents in community property States were taxed less heavily than residents in common law States prior to the adoption of the marital deduction.

[11] The maximum limitation on the amount of the State death tax credit is essentially a percentage of the rates of Federal estate tax that existed after World War I. After that war, there was pressure to repeal the estate tax. Instead of repealing the tax, Congress adopted the State death tax credit. The effect of the credit is to provide additional revenues to the States. Indeed, most States impose an additional tax commonly referred to as a "pick up" or "make up" tax, equal to the difference between the maximum State death tax credit and any inheritance or other succession taxes the State imposes. The effect of the "pick up" tax is to insure maximum revenues for the State without otherwise increasing the total death taxes paid by the decedent's estate and heirs.

7. Generation-skipping transfer tax

Under the Federal estate tax law, the gross estate generally includes only interests in property owned by the decedent at his or her death. For example, where an individual is given only an income interest in property for life, the gross estate of the individual does not include the value of the property generating the income because the income interest terminates at death and, consequently, the individual does not own any interest in such property at his or her death.[12] Moreover, the rules requiring inclusion of property where the decedent retained a life estate in previously transferred property do not apply in such a case because the income beneficiary did not create the income interest. Consequently, it is possible under the Federal estate tax law to transfer the beneficial enjoyment of property from one generation to another without estate tax (i.e., to skip a generation) by simply providing the intermediate generation with an income interest.

In order to prevent the avoidance of the Federal gift or estate taxes through the use of generation-skipping arrangements, Congress enacted the generation-skipping transfer tax as part of the Tax Reform Act of 1976. Under that Act, a new generation-skipping transfer tax is imposed on generation-skipping transfers under a trust or similar arrangement [13] upon the distribution of the trust assets to a generation-skipping beneficiary (for example, a great-grandchild of the transferor) or upon the termination of an intervening interest in the trust (for example, the termination of an interest held by the transferor's grandchild).

Basically, a generation-skipping trust is one which provides for a splitting of the benefits between two or more generations which are younger than the generation of the grantor of the trust. The generation-skipping transfer tax is not imposed in the case of outright transfers. In addition, the tax is not imposed if the grandchild has (1) nothing more than a right of management over the trust assets or (2) a limited power to appoint the trust assets among the lineal descendants of the grantor.

The tax is substantially equivalent to the tax which would have been imposed if the property had been actually transferred outright to each successive generation. For example, where a trust is created for the benefit of the grantor's grandchild, with remainder to the great-grandchild, then, upon the death of the grandchild, the tax is computed by adding the grandchild's portion of the trust assets to the grandchild's estate and taxable gifts and computing the additional tax at the grandchild's marginal transfer tax rate. In other words, for purposes of determining the amount of the tax, the grandchild is treated as a "deemed transferor" of the trust property.

The grandchild's marginal estate tax is used for purposes of determining the tax imposed on the generation-skipping transfer, but the grandchild's estate is not liable for the payment of the tax. Instead, the tax generally must be paid out of the proceeds of the trust property. However, the trust is entitled to any unused portion of the grandchild's unified transfer tax credit, the credit for tax on prior transfers, the charitable deduction (if part of the trust property is left to charity), the credit for State death taxes, and deduction for certain administrative expenses.

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[12] QTIP interests (discussed above) for which a marital deduction is claimed in the estate of the first spouse are included in the second spouse's estate under a special provision of the Code.

[13] For purposes of these rules, trust equivalents include life estates, estates for years, certain insurance and annuity contracts, and other arrangements where there is a splitting of the beneficial enjoyment of assets between generations.

8. Taxation of nonresident aliens

Gift tax

The Federal gift tax is imposed on nonresident aliens with respect to tangible real and personal property alocated within the United States. The regular gift tax rates apply. The rules are essentially the same as for citizens, except that the charitable deduction generally is allowed only for transfers to domestic charities and no marital deduction is allowed.

Estate tax

Present law imposes a separate estate tax on nonresident aliens (secs. 2101 to 2108). The tax is imposed only on the part of the gross estate that is situated in the United States. Deductions for expenses, indebtedness, taxes, and losses are allowed only for the proportion of the gross estate located within the United States. As in the case of the gift tax, the charitable deduction is allowed only for transfers to domestic charities and no marital deduction is allowed. There is a separate rate schedule which ranges from 6 percent on the first $100,000 in taxable estate to 30 percent on taxable estates of over $20 million. The unified credit is $3,600. Present law also imposes a special tax if an individual changes his or her United States citizenship within 10 years of death and one of the principal purposes of changing the citizenship was to avoid Federal gift, estate, or income taxes.

B. Summary of Legislative History [14]

1. 1797 to 1915

The first Federal involvement with an estate tax began in 1797 when Congress enacted a stamp tax on legacies, probates of wills and letters of administration. The stamp tax lasted until 1802 when it was repealed.

As a method of raising revenue to finance the Civil War, Congress enacted an inheritance tax [15] in 1862. Rates ranged up to 5 percent. The tax was repealed in 1870.

The next Federal estate tax [16] was imposed by the War Revenue Act of 1898. Rates ranged to 15 percent and there was an exemption of $10,000. The tax was repealed in 1902.

2. 1916 to present

1916 to 1942

The Revenue Act of 1916 imposed an estate tax that has remained in force until the present time, although it has been modified in numerous ways since then. The 1916 estate tax rates ranged from one percent on small estates to 10 percent on estates over $5 million. An exemption of $50,000 was allowed.

Between 1916 and 1942, the estate tax rates were raised or lowered on several occasions. The estate tax rates were raised twice in 1917. After these changes, the rates ranged from 2 percent on small estates to 25 percent on estates over $10 million. The Revenue Act of 1918 modified the estate tax by exempting estates of less than $1 million from the tax.

The Revenue Act of 1924 made several changes to the estate tax laws. It raised the top estate tax rate to 40 percent on estates over $10 million. It allowed a limited credit for State death taxes. The Revenue Act of 1924 also imposed a gift tax for the first time.

The Revenue Act of 1926 reduced the estate tax rates and repealed the gift tax. The maximum rate was reduced to 20 percent for estates over $10 million. The estate tax exemption was increased from $50,000 to $100,000, and the maximum credit for State death taxes was increased to 80 percent of the Federal estate tax.

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[14] For a more detailed history of the Federal gift and estate taxes, see Howard Zaritsky, "Federal Estate, Gift and Generation-Skipping Taxes: A Legislative History and a Description of Current Law", Congressional Research Service Report No. 80-76A (April 10, 1980).

[15] An inheritance tax is a tax imposed upon an individual's privilege of inheriting property from a decedent. Typically, the rates of an inheritance tax vary with the closeness of the familial relationship between the decedent and the heir. The rate schedule is applied separately to each heir. In contrast, an estate tax is a tax imposed on the decedent upon the privilege of leaving property to his or her heirs. The rate schedule is applied once to all property passing (or deemed to pass) at the decedent's death, regardless of the number of heirs or their familial relationship to the decedent.

[16] The Income Tax Act of 1894 treated gifts and inheritances as income and, thus, the tax was technically not an estate tax. The 1894 income tax act was held unconstitutional in 1895.

The Revenue Act of 1932 increased the estate tax rates, reduced the exemption to $50,000, and reenacted the gift tax. The top marginal rate under the 1932 Act was 45 percent on estates over $10 million. The gift tax rates were established at three-fourths of the estate tax rates, and there was an annual exclusion of $5,000 and a lifetime exemption of $50,000.

The Revenue Act of 1934 increased the top marginal estate tax rate to 60 percent on estates over $10 million. The Revenue Act of 1935 increased the top marginal rate to 70 percent on estates over $10 million and reduced the gift and estate tax exemptions to $40,000.

The Revenue Act of 1941 increased the gift and estate tax rates from 3 percent on small estates to 77 percent on estates over $10 million. The Revenue Act of 1942 modified the gift and estate exemptions and exclusions. Under the 1942 Act, the estate tax exemption was set at $60,000 and the gift tax exemption was set at $30,000. The annual gift tax exclusion was reduced from $5,000 to $3,000.

1943 to 1981

The rates and exemptions established by the Revenue Act of 1941 and 1942 remained in effect until the Tax Reform Act of 1976. The only other major change to the gift and estate taxes during this period was the introduction of the marital deduction by the Revenue Act of 1948. As stated above, the purpose of the marital deduction was generally to equate the tax treatment in common law States with the tax treatment in community law States.

The Tax Reform Act of 1976 modified the gift and estate tax laws in a number of ways. The most significant are as follows:[17] (1) the Act unified the gift and estate tax laws into the single cumulative transfer tax system based on combined lifetime and deathtime transfers;[18] (2) the rates were changed so that they began at 18 percent on small estates and increased to 70 percent on estates of over $5 million; (3) the gift tax and estate tax exemptions were combined and changed into a unified credit of $47,000, which allowed combined lifetime and deathtime transfers of $175,625 to be free from gift or estate taxes; (4) the marital deduction was increased to 100 percent of the first $100,000 of gifts and the first $250,000 of legacies and bequests to the spouse; (5) special valuation methods were provided for the valuation of certain real property used in farming or in other closely held businesses; and (6) a generation-skipping transfer tax was imposed.

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[17] The Tax Reform Act of 1976 also revised the income tax treatment of inherited property by providing that the basis of inherited property in the hands of the heir was the same as the basis of the property in the hands of the decedent with certain adjustments (i.e., a "carryover basis"). Under prior law, the basis of inherited property was its fair market value on the date of the decedent's death (or alternate valuation date, if elected). The carryover basis rules of the 1976 Act were repealed retroactively by the Crude Oil Windfall Profits Tax Act of 1980.

[18] Prior to enactment of the Tax Reform Act of 1976, the amount of lifetime transfers generally did not affect the amount of estate tax because there were separate rate schedules for both the gift tax and the estate tax. Under the unified system of the Tax Reform Act of 1976, deathtime transfers, in essence, are treated as the last gift of the decedent under a single rate schedule.

1982 to present

The Economic Recovery Tax Act of 1981 further modified the gift and estate tax laws in several significant ways. The Act increased the unified credit to an equivalent amount of $600,000 (phased in over 6 years), and reduced the maximum rate from 70 percent to 50 percent (phased in over 4 years). An unlimited marital deduction was provided and certain terminable interests i.e., so-called QTIP property became eligible for the deduction for the first time. The gift tax annual exclusion was increased from $3,000 to $10,000 per donee. Rules governing the installment payment of estate tax attributable to interests in closely held businesses and the current use valuation of certain real property were liberalized.

Finally, ERTA made a number of other modifications to the gift and estate tax rules, including repeal (for most purposes) of the rule that gifts made by an individual within three years of death must be included in the individual's gross estate; elimination of a step-up in basis if appreciated property is acquired by gift by the individual within one year of death and then is returned to the donor or the donor's spouse; repeal of the orphan's exclusion; annual filing of gift tax returns; one-year extension of the transition rule for certain wills or revocable trusts under the tax on generation-skipping transfers; and allowance of a charitable deduction for gift and estate tax purposes for certain bequests or gifts of copyrightable works of art, etc., when the donor retains the copyright.

C. Statistical Information

1. Federal revenues

Prior to 1916, estate taxes were used primarily to raise revenue. Since 1916, the gift and estate taxes have been used to raise revenues and for other purposes such as preventing undue concentrations of wealth and complementing the income tax to fullfill the goal of the progressive tax system. Table 1 compares the revenue from the estate tax as a percent of all Federal revenues from the period 1925 to the present. As indicated, estate taxes have accounted for less than 2 percent of Federal revenues since World War II. Table 2 provides estimates of the revenues from gift and estate taxes from 1981 to 1985 based upon existing rates and credits.

Table 1.—Gift and Estate Tax Revenues as a Percent of Total Federal Revenue, Selected Years—1925 to Present

[In millions of dollars]

Year	Net estate tax[19]	Total Federal	Percent of revenues attributable to estate revenue[20] tax
1925	$86	$3,641	2.4
1930	39	4,058	1.0
1935	154	3,706	4.2
1940	250	6,879	3.6
1945	531	50,162	1.1
1950	484	40,940	1.2
1955	778	65,469	1.2
1961	1,619	94,389	1.7
1963	1,841	106,560	1.7
1966	2,414	130,856	1.8
1970	3,000	193,743	1.5
1977	4,979	357,762	1.4
1981	8,035	614,735	1.3
1982	6,827	618,221	1.1
1983 (est.)	5,723	627,914	0.9

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[19] Calendar year receipts. (Note: calendar year receipts of estate tax generally are received in the next subsequent fiscal year.)

[20] Fiscal year receipts.

Table 2.—Federal Gift and Estate Tax Revenues, Fiscal Years 1983–1988

[In millions of dollars]

1983	1984	1985	1986	1987	1988
6,114	5,902	5,611	5,097	4,595	4,287

2. State revenues

As indicated above, present law allows a limited credit against Federal estate tax for death taxes paid to a State. Typically, most States impose an inheritance tax and, in addition, impose an estate tax, commonly called a "pick up" or "make up" tax equal to the difference between the maximum State death tax credit and any inheritance taxes imposed on property passing from the decedent. Table 3 sets forth the aggregate amount of the State death tax credit for the period 1925 to the present. This can be considered an additional burden of the Federal estate tax, although the revenue goes to the State governments, not the Federal Government.

Table 3.—Credit for State Inheritance Taxes Paid, Selected Years—1925 to Present

[In millions of dollars]

Year	Amount
1925	$11
1930	113
1935	44
1940	45
1945	65
1950	49
1955	86
1961	196
1963	208
1966	280
1970	333
1977	552
1981	896
1982	984
1983 (est.)	1,073

3. Historical distribution of the estate tax

Table 4 provides a comparison from 1925 until the present of (1) the number of taxable estate tax returns filed; (2) the number of estates paying estate tax, expressed as an absolute number and as a percentage of all individuals dying in that year; (3) the aggregate dollar amount of gross estate of all estate tax returns filed for that year; (4) the aggregate dollar amount of taxable estate of all estates paying tax for that year; (5) the aggregate dollar amount of estate tax paid for that year; and (6) the average estate tax rate of estates paying tax during that year.

Table 4.—Selected Federal Estate Tax Data, Selected Years—1925 to Present

[In millions of dollars]

Taxable returns							
Year	Number of returns	Number of taxable returns	Percent of all decedents	Gross estate	Taxable estate	Net estate tax	Average tax rate
1925	14,013	10,642	0.8	$2,958	$1,621	$86	5.3
1930	8,798	7,028	.5	4,109	2,377	39	1.6
1935	11,110	8,655	.6	2,435	1,317	154	11.7
1940	15,435	12,907	.9	2,633	1,479	250	16.9
1945	15,898	13,869	1.0	3,437	1,900	531	27.9
1950	25,858	17,411	1.2	4,918	1,917	484	25.2
1955	36,595	25,143	1.6	7,467	2,991	778	26.0
1961	64,538	45,439	2.7	14,622	6,014	1,619	26.9
1963	78,393	55,207	3.0	17,007	7,071	1,841	26.0
1966	97,339	67,404	3.6	21,936	9,160	2,414	26.4
1970	133,944	93,424	4.9	29,671	11,662	3,000	25.7
1977	200,747	139,115	7.3	48,202	20,904	4,979	23.8
1981	114,720	74,607	3.7	52,641	31,856	8,035	25.2
1982	85,386	55,530	2.8	55,273	33,449	6,827	20.4
1983(est.)	68,537	47,863	2.4	57,446	34,874	5,723	16.4

III. DESCRIPTION OF BILLS AND RESOLUTION

A. S. 309—Senators Laxalt and Hecht

Special Estate Tax Credit for the Estate of Nell J. Redfield

Present Law

A deduction generally is allowed for estate tax purposes for certain amounts transferred for charitable purposes (Code sec. 2055). The United States is a qualified donee of such deductible transfers. Credits against estate tax are not provided for transfers for charitable purposes.[20A]

If an estate has an estate tax liability after taking into account all allowable deductions and credits, that liability generally must be paid in cash or a cash equivalent (i.e., check or money order) (sec. 6311). Certain series of Treasury bonds ("flower bonds") may also be used to pay estate tax. To be eligible, these bonds must have been issued as part of certain pre-March 4, 1971, series of bonds, have been owned by the decedent at the time of his or her death, and have been included in the decedent's gross estate (sec. 6312).

Except in a case where the Internal Revenue Service must levy to secure payment of tax, real property and personal property other than cash or flower bonds cannot be used to pay estate tax.

Issues

The primary issue is whether a special estate tax credit in lieu of the regular charitable deduction provision should be permitted for a transfer of real property to the United States for addition to the national forest system.

A secondary issue is whether estate tax revenues should be dedicated to specific purposes that are presently funded by appropriations (i.e., expansion of the national forest system) rather than deposited in the general fund of the Treasury (as presently is done).

Explanation of Provisions

The bill would provide a special credit against Federal estate tax imposed on the Estate of Nell J. Redfield. The credit would apply to the transfer, without reimbursement or payment, to the Secretary of Agriculture for addition to the Toiyabe National Forest of

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[20A] A similar credit to that proposed by the bill was allowed by the Tax Reform Act of 1976 to the Estate of LaVere Redfield, the husband of Nell Redfield, for property transferred to the Toiyabe National Forest.

In addition, the Economic Recovery Tax Act of 1981 permitted a credit to the Estate of Dorothy Meserve Kunhardt for the transfer of certain Matthew Brady glass plate negatives and the Alexander Gardner imperial portrait print of Abraham Lincoln to the Smithsonian Institution.

real property located within or adjacent to the boundaries of that national forest.

The amount of the credit would be equal to the lesser of (1) the fair market value of the transferred property as determined for Federal estate tax purposes or (2) the estate's Federal estate tax liability (plus interest thereon).

Effective Date

The provisions of the bill would be effective on the date of the bill's enactment.

Revenue Effect

It is estimated that this bill would produce a one-time revenue loss of $17.5 million in fiscal year 1984.

B. S. 310—Senators Laxalt and Hecht

Special Estate Tax Credit for the Estate of Elizabeth Schultz Rabe

Present Law

A deduction generally is allowed for estate tax purposes for certain amounts transferred for charitable purposes (Code sec. 2055). The United States is a qualified donee of such deductible transfers. Credits against estate tax are not provided for transfers for charitable purposes.

If an estate has an estate tax liability after taking into account all allowable deductions and credits, that liability generally must be paid in cash or a cash equivalent (i.e., check or money order) (sec. 6311). Certain series of Treasury bonds ("flower bonds") may also be used to pay estate tax. To be eligible, these bonds must have been issued as part of certain pre-March 4, 1971, series of bonds, have been owned by the decedent at the time of his or her death, and have been included in the decedent's gross estate (sec. 6312).

Except in a case where the Internal Revenue Service must levy to secure payment of tax, real property and personal property other than cash or flower bonds cannot be used to pay estate tax.

Issues

The primary issue is whether a special estate tax credit in lieu of the regular charitable deduction provision should be permitted for a transfer of real property for addition to the national forest system.

A secondary issue is whether estate tax revenues should be dedicated to specific purposes that are presently funded by appropriations (i.e., expansion of the national forest system) rather than deposited in the general fund of the Treasury (as is presently done).

Explanation of Provisions

The bill would provide a special credit against Federal estate tax imposed on the Estate of Elizabeth Schultz Rabe. The credit would apply to the transfer, without reimbursement or payment, of approximately 97.6 acres of property located in Douglas County, Nevada, to the Secretary of Agriculture for addition to the Toiyabe National Forest.

The amount of the credit would be equal to the lesser of (1) the fair market value of the transferred property as determined for Federal estate tax purposes or (2) the estate's Federal estate tax liability (plus interest thereon).

Effective Date

The provisions of the bill would be effective on the date of the bill's enactment.

Revenue Effect

It is estimted that this bill would produce a one-time revenue loss of $3 million in fiscal year 1984.

C. S. 953—Senator Laxalt

To Permit Current Use Valuation Elections on Amended Estate Tax Returns

Present Law

If certain requirements are satisfied, present law permits real property used in family farming operations and other closely held businesses to be included in a decedent's gross estate at its current use value, rather than its full fair market value, provided that the gross estate may not be reduced by more than $750,000 (Code sec. 2032A).

An estate may qualify for current use valuation if: (1) the decedent was a citizen or resident of the United States at his or her death; (2) the value of the farm or closely held business assets in the decedent's estate including both real and personal property (but reduced by secured debts attributable to the real and personal property), is at least 50 percent of the decedent's gross estate (reduced by secured debts); (3) at least 25 percent of the adjusted value of the gross estate is qualified farm or closely held business real property;[21] (4) the real property qualifying for current use valuation passes to a qualified heir;[22] (5) such real property has been owned by the decedent or a member of the decedent's family and used or held for use as a farm or closely held business ("a qualified use") for 5 of the last 8 years prior to the decedent's death; and (6) there has been material participation in the operation of the farm or closely held business by the decedent or a member of his or her family for periods aggregating 5 years out of the 8 years immediately preceding the decedent's death or the earlier beginning of the decedent's retirement or disability that lasted until the date of death (secs. 2032A (a) and (b)).

Before 1982, the current use valuation provision was available only if the executor of the decedent's estate made an election within 9 months after the date of death (15 months if an extension of time to file the estate tax return was granted) (sec. 2032A(d)(1)).

The Economic Recovery Tax Act of 1981 amended this requirement to permit current use valuation elections to be made on a late-filed return so long as the election is made on the first estate tax return filed. ERTA also provided that the election is irrevocable, once made.

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[21] For purposes of the 50-percent and 25-percent tests, the value of property is determined without regard to its current use value.

[22] The term "qualified heir" means a member of the decedent's family, including his or her spouse, lineal descendants, parents, and their descendants.

Explanation of Provisions

The bill would permit current use valuation elections to be made on amended estate tax returns, as well as on the first return filed.

Effective Date

The provisions of the bill would apply to estates of decedents dying after December 31, 1976, provided the period of limitations for assessing estate tax has not expired before the date of the bill's enactment.

While estates of other decedents may be affected by enactment of the bill, the primary beneficiary of the retroactive effective date of bill is intended to be the Estate of Don B. Harris.

Revenue Effect

It is estimated that this bill would reduce Federal budget receipts by $5 million annually.

D. S. 1180—Senators Symms and Wallop

Tax Treatment of Certain Disclaimers

Present Law

In general, a disclaimer is a refusal to accept the ownership of property or rights with respect to property. If a qualified disclaimer is made, the Federal gift, estate, and generation-skipping transfer tax provisions apply with respect to the property interest disclaimed as if the interest had never been transferred to the person making the disclaimer. Thus, the transfer of property pursuant to the disclaimer will not be treated as a taxable gift.

Prior to the enactment of Code section 2518 in 1976, there were no uniform Federal disclaimer rules. Before the promulgation of Treasury regulations in 1958, the administrative practice of the Internal Revenue Service was to allow the Federal tax consequences of a disclaimer to depend upon its treatment under local law.

On November 14, 1958, the Treasury Department issued regulations (T.D. 6334) which required that a disclaimer (1) be effective under local law and (2) notwithstanding the timeliness of the disclaimer under local law, be made "within a reasonable time after knowledge of the existence of the transfer." In litigating this issue, the Treasury interpreted these regulations to require that a disclaimer be made within a reasonable time after the creation of the interest, rather than the time at which the interest vested, or became possessory. Thus, for example, where property was transferred to X for life, remainder to Y, both X and Y were required to disclaim within a reasonable time of the original transfer, although Y could not take possession of the property until X's death.

These regulations also applied to interests created in transfers before November 15, 1958. Thus, under the regulations, a disclaimer of an interest created in a transfer before to November 15, 1958, would be qualified for Federal tax purposes only if it were made within a reasonable time after the original transfer creating the interest.

This dispute as to the timing of a qualified disclaimer generated considerable litigation, with conflicting results. The Tax Court upheld the Treasury position in a series of cases including *Jewett* v. *Commissioner,* 70 T.C. 430 (1978), *Estate of Halbach* v. *Commissioner,* 71 T.C. 141 (1978), and *Cottrell* v. *Commissioner,* 72 T.C. 489 (1979). However, the Circuit Courts were divided on the issue. The Eighth Circuit rejected Treasury's position, concluding that State law determines the validity of a disclaimer in *Keinath* v. *Commissioner* 480 F.2d 57 (1973) and *Cottrell* v. *Commissioner,* 628 F.2d 1127 (1980). However, the Ninth Circuit upheld the decision in *Jewett* v. *Commissioner* in 1980 (638 F.2d 93) and the Supreme Court granted *certiorari.*

On February 23, 1982, the Supreme Court resolved the controversy in *Jewett* v. *Commissioner* [23] by upholding the Treasury position. Noting that the Treasury interpretation is entitled to respect because it has been consistently applied over the years, the Court concluded that the relevant "transfer" occurs when the interest is created and not at such later time as the interest vests or becomes possessory.

In the Tax Reform Act of 1976, Congress adopted a set of uniform rules to govern disclaimers of property interests transferred after December 31, 1976 (sec. 2518). Under that section, a disclaimer generally is effective for Federal gift and estate tax purposes if it is an irrevocable and unqualified refusal to accept an interest in property and meets four other conditions. First, the refusal must be in writing. Second, the written refusal generally must be received by the person transferring the interest, or the transferor's legal representative, no later than nine months after the transfer creating the interest.[24] Third, the disclaiming person must not have accepted the interest or any of its benefits before making the disclaimer. Fourth, the interest must pass to a person other than the person making the disclaimer or to the decedent's surviving spouse as a result of the refusal to accept the interest.[25]

Issue

The issue is whether a disclaimer by an individual of an interest created before November 15, 1958, should be effective for Federal gift and estate tax purposes where the disclaimer is made subsequent to a reasonable period after the creation of the interest.

Explanation of Provisions

Under the bill, a disclaimer of an interest created by a transfer made before November 15, 1958, would be treated as a qualified disclaimer if it meets the requirements of section 2518, other than the requirement that the disclaimer be made within nine months of the transfer creating the interest, and if the disclaimer is received by the transferor of the interest not later than 90 days after the date of the bill's enactment.

Effective Date

The bill would apply to disclaimers made with respect to transfers made before November 15, 1958.

Revenue Effect

This bill would have a negligible effect on Federal budget receipts, however government outlays are estimated to be increased by $30 million in fiscal year 1984, $10 million in 1985 and by less than $5 million for subsequent years.

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[23] 50 U.S.L.W. 4215; 82-1 USTC ¶ 13,453; 49 AFTR 2d 148,104.

[24] However, the period for making the disclaimer is not to expire until nine months after the date on which the person making the disclaimer has attained age 21.

[25] In addition, with respect to interests created after December 31, 1981, certain transfers to the person or persons who would have otherwise received the property if an effective disclaimer had been made under local law, may be treated as qualified disclaimers, provided the transfers are made timely and the transferor has not accepted the transferred interests or any of their benefits.

E. S. 1210—Senators Baker and Sasser

Election of Alternate Valuation Date on Late Estate Tax Return

Present Law

Under present law, the executor of a decedent's estate may elect to value the property in the gross estate as of the date of the decedent's death or the "alternate valuation date," which is generally six months after the date of the decedent's death (code sec. 2032). Alternate valuation provides estate tax relief when property in a decendent's estate declines in value shortly after the decedent's death. Alternate valuation must be elected by the executor on an estate tax return filed within nine months of the date of death (15 months if an extension of time in which to file the estate tax return is granted).[26] Except in the case of taxpayers who are abroad, the Internal Revenue Service has no authority to grant an extension exceeding six months.

Issue

The issue is whether an executor should be permitted to elect alternate valuation on an estate tax return that is not timely filed, and if so, what should be the effective date of the change.

Explanation of Provisions

The bill would permit the alternation valuation date to be elected on late-filed estate tax returns provided the returns were the first such returns filed by the estates and provided that (1) the returns were filed not more than one year after the due date (including extensions) or (2) one of the principal purposes for the late filings was not the making of the election.

The bill also would amend the alternate valuation provision to permit its election only if estate tax (in excess of the unified credit) were shown due on the first estate tax return filed. Additionally, the election would be permitted only if the executor determined in good faith that the value of the gross estate was less on the alternate valuation date than on the date of death and filed a statement to that effect with the return.

Effective Date

The provisions of the bill generally would apply to estates of decedents dying after the date of the bill's enactment.

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[26] An executor may elect alternate valuation by checking a box on Form 706, United States Estate Tax Return. An executor's failure to check the appropriate box on a timely filed Form 706 may not prevent the use of alternative valuation where the entries on the form are otherwise consistent with an election of alternate valuation (Rev. Rul. 61-128. 1961-2 C.B. 150).

The bill includes a transitional rule applicable to estates of decedents dying before the date of the bill's enactment whose estate tax returns were filed after their due date if the estate would have been eligible for the election had the decedent died after the date of the bill's enactment. The transitional rule would permit an effective election of alternate valuation to be made within one year after enactment of the bill by filing a written notice with the Internal Revenue Service. If an election were made under the transitional rule, an assessment of a deficiency in tax could be made within two years of the election although such assessment would otherwise be barred.

The retroactive provisions of the bill primarily are intended to benefit the Estate of Sylvia Buring.

Revenue Effect

It is estimated that this bill would have a negligible effect on Federal budget receipts.

F. S. 1250—Senator Symms

Repeal of Gift, Estate and Generation-Skipping Transfer Taxes

Present Law

Under present law, a gift tax is imposed on inter vivos transfers and an estate tax is imposed on deathtime transfers. The rates of tax begin at 18 percent on the first $10,000 of transfers and reach 60 percent for transfers in excess of $3.5 million. Deductions are allowed for transfers to spouses (marital deduction) and to charities (charitable deduction). Gift and estate taxes can be reduced by a unified credit of $79,300 (which permits the transfer of $275,000 free of gift or estate tax). This credit is scheduled to increase in annual increments through 1987, at which time the credit will permit transfers up to $600,000 without tax. In addition, present law imposes a generation-skipping transfer tax on transfers if beneficiaries of more than one generation receive interests in the transferred property.

Issue

The issue is whether the gift, estate, and generation-skipping transfer taxes should be repealed.

Explanation of Provisions

The bill would repeal the gift, estate, and generation-skipping transfer taxes. In addition to several conforming changes to other provisions of the Code, the bill also would provide that—

(1) Expenses of the decedent's last illness, paid within one year of the death, would be deductible under Code section 213 in computing the decedent's income tax for the year of his or her death as if the expenses had been paid when incurred; and

(2) Section 303, which accords capital gains treatment for amounts received in redemptions of corporate stock to pay death taxes and administration expenses, would be repealed.

Effective Date

The provisions of the bill would apply with respect to decedents dying after December 31, 1982, and to gifts made after that date.

Revenue Effect

It is estimated that this bill would reduce Federal budget receipts by $5,902 million in fiscal year 1984, $5,611 million in 1985, $5,097 million in 1986, $4,595 million in 1987, and by $4,287 million in 1988.

G. S. 1251—Senators Symms, Wallop, Boren, Grassley, Bentsen, and others

"Section 6166 Technical Revision Act of 1983"

Present Law

Overview

In general, estate tax must be paid within 9 months after a decedent's death. However, if certain requirements are satisfied and the executor makes an election,[27] payment of estate tax attributable to certain interests in closely held businesses can be extended and paid in installments over 14 years (interest for 4 years followed by from 2 to 10 annual payments of principal and interest) (code sec. 6166).[28] A special 4-percent interest rate is provided for tax attributable to the first $1 million in value of the closely held business interest (sec. 6601(j)).[29] Tax in excess of this amount ($345,800 less the amount of decedent's unified credit) accrues interest at the regular rate charged on deficiencies (sec. 6601(a)). The regular deficiency rate currently is 16 percent. The rate is scheduled to be reduced further, to 11 percent, on July 1, 1983.

Qualification requirements

To qualify for the installment payment provision, at least 35 percent of the value of the decedent's adjusted gross estate must consist of the value (net of business indebtedness) of an interest in a closely held business. Under section 6166, all businesses owned by the decedent and carried on as a proprietorship qualify as an interest in a closely held business. In addition, an interest in a closely held business includes interests in partnerships and corporations if certain "percentage tests" or "numerical tests" are satisfied. An interest of a partner in a partnership carrying on a trade or business qualifies if—

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[27] The election must be made within 9 months after the decedent's death (15 months if an extension of time to file the decedent's estate tax return is granted) (secs. 6166(d) and 6081). If a deficiency is later assessed, the deficiency is prorated among the installment payments to the extent that it would have been eligible for extended payment had the amount been shown on the estate tax return and if the deficiency was not due to negligence or intentional disregard of rules and regulations (sec. 6166(e)). Additionally, a special election is available to pay deficiency amounts in installments where (1) no installment payment election was initially made, (2) the estate, after examination, meets all requirements of the provisions, and (3) the deficiency was not due to negligence or intentional disregard of rules and regulations (sec. 6166(h)).

[28] Because eligibility for the installment payment provision relates to the time of payment rather than the amount of tax, the decision of the Internal Revenue Service as to an estate's eligibility or as to acceleration of unpaid tax is not subject to judicial review under present law.

[29] While the installment payment provision is generally explained as deferring estate tax attributable to closely held business property, that is not always true. The estate may extend payment of a percentage of its tax equal to the percentage of the adjusted gross estate which the business property comprises. This extension is available even if the inclusion of the business property does not result in any additional estate tax—as, for example, where it passes tax-free to a surviving spouse pursuant to the marital deduction.

(a) 20 percent or more of the value of the total capital interest in the partnership in included in the value of the decedent's gross estate ("percentage test"); or

(b) the partnership has 15 or fewer partners ("numerical test").

Stock in a corporation carrying on a trade or business qualifies if—

(a) 20 percent or more in value of the voting stock in the corporation is included in the value of the decedent's gross estate ("percentage test"); or

(b) the corporation has 15 or fewer shareholders ("numerical test").[30]

Attribution rules

Present law contains rules under which property owned by certain other persons is treated as owned by the decedent for purposes of determining whether the decedent's interest was an interest in a closely held business ("attribution rules"). These attribution rules are of two types—automatic and elective. Under these attribution rules, stock and partnership interests held by a husband and wife as community property or as joint tenants, tenants by the entirety, or tenants in common, are treated as owned by the decedent in determining the number of shareholders or partners a corporation or a partnership has. Additionally, all stock and partnership interests owned by members of the decedent's family[31] are treated as owned by the decedent. To prevent the use of trusts, corporations, and partnerships to avoid the numerical qualification tests for corporations and partnerships, the installment payment provision provides that property owned directly or indirectly by a corporation, partnership, estate, or trust is treated as owned proportionately by the owners of the entity.

The elective attribution rules permit an executor to elect to treat capital interests in partnerships and nonreadily tradable stock[32] owned by members of the decedent's family as owned by the decedent to determine whether the decedent owned 20 percent or more of voting stock or partnership capital in the closely held businesss (i.e., satisfied the percentage tests). If the elective attribution rules are used to qualify a business interest for the installment payment provision, the estate is not entitled to the special 4-percent interest rate or the initial 5-year deferral period for principal.

Aggregation rules

Present law also permits "aggregation" of interests in multiple closely held businesses to qualify an estate for the installment payment provision if 20 percent or more of the total value of each aggregated business is included in the value of the decedent's gross estate. Under the aggregation rules, the value of property owned by a surviving spouse with the decedent as community property, joint tenants, tenants by the entirety, or tenants in common is treated as owned by the decedent.

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[30] In the case of proprietorships, Treasury regulations provide that only assets actually used in the business are considered for purposes of the "35 percent of adjusted gross estate" test. In the case of partnerships and corporations, on the other hand, all partnership and corporate assets are considered even where some of the assets are not actually used in the business operation (Treas. Reg. sec. 20.6166A-2(c)).

[31] Family members include an individual's brothers and sisters, spouse, ancestors, and lineal descendants (sec. 267(c)(4)).

[32] Nonreadily tradable stock is stock for which there was no market on a stock exchange or over the counter market at the time of the decedent's death.

Definition of trade or business

Under present law, the installment payment election is available only for interests in active trades or businesses as opposed to passive investment assets. The Congressional intent that this provision not apply to all businesses or investment assets is illustrated by the Report of the Committee on Ways and Means on the Small Business Tax Revision Act of 1958 (H. Rept. No. 2198),[33] where the committee stated,

> The bill is to aid and encourage small business. It is not, however, an attempt to settle all of the small-business's problems, even in the area of Federal taxation.
>
> The . . . goal of the bill is to prevent the breakup of small businesses once they are established, and to prevent their consolidation into larger businesses. To aid in this respect your committee has provided up to 10 years for payment of estate taxes where investments are in a closely held business. This should make it unnecessary to sell a decedent's business in order to finance his estate tax.

The determination of whether an interest in an active trade or business is present is factual and must be made on a case-by-case basis. In interpreting the legislative history of the provision, the Internal Revenue Service takes the position that a passive holding company is not carrying on an active trade or business. Further, the Service takes the position that the holding company is not pierced to determine whether any subsidiary owned in part or in whole by it is carrying on an active trade or business. Likewise, the Service takes the position that assets passively leased to a separate active business, in which the decedent also owns an interest, do not constitute an active trade or business for purposes of the installment payment provision. The most detailed guidelines on what constitutes a trade or business under the installment payment provision are found in three 1975 revenue rulings—Rev. Rul. 75-365, 1975-2 C.B. 471; Rev. Rul. 75-366, 1975-2 C.B. 472; and Rev. Rul. 75-367, 1975-2 C.B. 472—issued under former section 6166A.[34]

In Rev. Rul. 75-365, supra, the IRS ruled that rental commercial property, rental farm property, and notes receivable did not constitute a trade or business within the meaning of the installment payment provision. The Service stated that the determination of what constitutes a trade or business is not made merely by reference to a broad definition of business or by reference to case law under section 162. It noted that—

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[33] The Small Business Tax Revision Act was enacted as Title II of the Technical Amendments Act of 1958 (P.L. 85-866, approved September 2, 1958). That Act included the predecessor provision to the present installment payment provision.

[34] Section 6166A, designated section 6166 before 1977, provided for payment of estate tax attributable to interests in closely held businesses in from 2 to 10 annual installments. Section 6166A was repealed by the Economic Recovery Tax Act of 1981, effective for estates of individuals dying after December 31, 1981.

> Although the management of real property by the owner may, for some purposes, be considered the conduct of business in the case of a sole proprietorship (the installment payment provision applies) only with respect to a business such as a manufacturing, mercantile, or service enterprise, as distinguished from management of investment assets.
>
> It follows that the mere grouping together of income-producing assets from which a decedent obtained income only through ownership of the property rather than from the conduct of a business, in and of itself, does not amount to an interest in a closely held business within the intent of the statute. (*Id.*).

Rev. Rul. 75-366, supra, applied the trade or business test in a farming situation. In that case, the decedent leased real property to a tenant on a crop share basis. In addition to sharing in the farm expenses and production, the decedent actively participated in important management decisions. The decedent was held to be in the business of farming under these facts, the Service saying—

> An individual is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant, and if he receives a rental based upon farm production rather than a fixed rental. Farming under these circumstances is a productive enterprise which is like a manufacturing enterprise as distinguished from management of investment assets.
>
> In the present case the decedent had participated in the management of the farming operations and his income was based upon the farm production rather than on a fixed rental.
>
> Accordingly, the farm real estate included in the decedent's estate qualifies . . . as an interest in a closely held business. (Id.).

Finally, Rev. Rul. 75-367, supra, held that a subchapter S corporation engaged in home construction was a trade or business within the meaning of the installment payment provision, but ownership and management of eight rental homes was not. The ruling also held that a proprietorship that developed land and sold new homes built by the construction company was carrying on a trade or business. In that ruling, the Service construed Congressional intent in enacting the installment payment provision as being to permit—

> * * * (T)he deferral of the payment of the Federal estate tax where, in order to pay the tax, it would be necessary to sell assets used in a going business and thus disrupt or destroy the business enterprise. This (provision) was not intended to protect continued management of income producing properties or to permit deferral of the tax merely because the payment of the tax might make necessary the sale of income-producing assets, except where they formed a part of an active enterprise producing business income rather than income solely from the ownership of property. Id. at 473.

When interests in oil and gas ventures constitute a trade or business within the meaning of the installment payment provision was the subject of a separate ruling by the IRS. In Rev. Rul. 61-55, 1961-1 C.B. 713, the Service held that ownership, exploration, development, and operation of oil and gas properties is a trade or business, but the mere ownership of royalty interests is not.[35]

Acceleration of unpaid tax

The right to defer payment of estate tax is terminated upon the occurrence of certain events during the 14-year extension period. If such a termination occurs, all unpaid installments of tax and accrued interest are accelerated and are payable on notice and demand from the IRS.

Disposition of interest and withdrawal of funds from the business

If the persons receiving property from the decedent whose estate elects the installment payment provision make cumulative dispositions of the interest in the business and withdrawals from the business totaling 50 percent or more of the value of the decedent's interests, all unpaid installments and interest are accelerated. Generally, mere changes in form of ownership are not treated as dispositions.[36] Additionally, the Economic Recovery Tax Act of 1981 provided a new exception which excludes dispositions by reason of death of the heir (or a subsequent transferee) from this rule. However, this exception applies only if the property is transferred to a member of the deceased heir's (or subsequent transferee's) family.

A further exception is provided for withdrawals from a corporation pursuant to a redemption under section 303, but only if all proceeds of the redemption are used to pay Federal estate taxes no later than the due date of the first installment becoming due after the redemption (or one year after the redemption, if earlier).[37]

Undistributed income of estate

If an estate has undistributed net income in any year, the income must be applied against unpaid installments by the due date of the estate's income tax return, or the unpaid tax and accrued interest is accelerated.

Late payments of principal or interest

In general, if an estate fails to make any payment of principal or interest by its due date, all unpaid amounts are accelerated. A limited exception is provided for late payments received within six months after the due date. However, such late payments are not eligible for the special 4-percent interest rate, and the estate must pay a special penalty of 5 percent of the payment for each month (or part thereof) that the payment is late.

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[35] Under present income tax law, co-ownership of working interests in an oil and gas lease is treated as a partnership; however, if the co-owners elect, they will be treated as proprietors rather than partners (sec. 761(a)). This "election-out" of partnership treatment is not available for estate tax purposes.

[36] Under present law, a corporate reorganization which is not an income taxable event under section 368(a)(1) (D), (E), (F) is not treated as a disposition of an interest in the business for purposes of accelerating unpaid installments of tax. Likewise, certain dispositions of stock in controlled corporations (sec. 355) are not treated as dispositions.

[37] Section 303 provides special tax treatment for redemptions of corporate stock to the extent that the redemption proceeds to a shareholder do not exceed the total death taxes (including, but not limited to, Federal estate taxes) imposed by reason of the decedent shareholder's death and the amount of funeral and administration expenses allowable as an estate tax deduction to the estate.

Deductibility of interest

Interest accrued as a result of extending payment of tax under the installment payment provision is deductible by the estate. The interest may be claimed as an administration expense in determining estate tax (sec. 2053) or may be claimed as an income tax deduction. The executor must elect the manner in which the deduction is to be claimed (sec. 642(g)).

In general, interest is only deductible for estate tax purposes when it is actually paid. The IRS holds that this general rule applies also to interest on tax payment of which is extended under the installment payment provision (Rev. Rul. 80-250, 1980-2 C.B. 278). Therefore, if an estate elects to claim such interest as an estate tax deduction, an amended estate tax return must be filed each year as the interest is paid. The interest deduction reduces the decedent's estate tax, and this reduction is reflected in reductions in the unpaid installments (Rev. Proc. 81-27, 1981 I.R.B. 21).

Other extensions of time to pay estate tax

If an estate is not eligible to defer estate tax under the installment payment provision, payment of the tax may be extended under the general estate tax extension of time to pay. Present law permits an extension of time to pay tax for up to 10 years upon a showing of reasonable cause. This extension is granted for a maximum period of one year at a time and can be renewed annually (as long as the reasonable cause continues to exist). One situation in which reasonable cause is present is where an estate does not have sufficient funds to pay the tax when otherwise due without borrowing at a rate of interest higher than that generally available (Treas. Reg. sec. 20.6161-1(a)).

Issues

The principal issue is whether the installment payment provision should be expanded to allow estate tax attributable to additional types of business investments.

A second issue is whether the circumstances under which estate tax deferred under the installment payment provision is accelerated should be liberalized.

A third issue is whether the normal rule that interest is deductible for estate tax purposes only when paid should be changed in the case of interest accruing on estate tax deferred under this provision so as to permit a deduction for the full amount of interest which might be paid when the estate tax return is filed.

A fourth issue is whether an interest rate, other than the regular deficiency rate, should apply to extended amounts of tax in excess of amounts subject to the special 4-percent rate of present law.

A final issue is whether decisions of the Internal Revenue Services as to qualification of an estate for the installment payment provision or acceleration of unpaid tax should be subject to judicial review even though the amount is not in dispute.

Explanation of Provisions

Overview

The bill would expand the types of assets that are eligible for special treatment under the installment payment provision as an interest in a closely held business in several ways, would liberalize the rules under which unpaid installments of tax and interest are accelerated, would provide a new interest rate on deferred tax and new rules on the deductibility of that interest, and would provide for judicial review of IRS determinations under the provision.

Qualification requirements

General rules

The bill would expand the types of business interests that qualify for the installment payment provision in numerous ways. First, the bill would increase the number of partners or shareholders a closely held business can have under the numerical tests for qualifying an interest in a partnership or corporation as an interest in a closely held business from 15 to 35. Thus, under the bill, if a partnership or corporation had 35 or fewer partners or shareholders, the numercial test would be satisfied.

The bill would count interests in partnership profits under the percentage test for qualifying interests in a partnership as an interest in a closely held business. Only interests in partnership capital are counted under present law. Thus, under the bill, if the decedent owned capital or profits interests in a partnership, or a combination of the two, totaling 20 percent or more of the value of the business, the percentage test would be satisfied.

The bill would count nonvoting stock under the percentage test for qualifying an interest in a corporation as an interest in a closely held business. Only voting stock is counted under present law. Thus, under the bill, if the decedent owned voting or nonvoting stock, or a combination of the two, totaling 20 percent or more of the value of the business, the percentage tests for corporations would be satisfied.

The bill would treat certain notes and other evidences of indebtedness as interests in closely held businesses (in addition to stock and partnership interests which are considered under present law) in determining whether the decedent owned an interest in a closely held business. This type of interest would be considered in addition to, or in combination with, corporate stock or interests in partnership profits and capital. Only debt interests acquired in exchange for stock and partnership interests owned by the decedent or for money which the decedent loaned the business more than one year before his or her death, would be considered. Thus, under the bill, the fact that the decedent withdrew from the business by selling the decedent's interest pursuant to a "buy-out" agreement with another owner who planned to continue the business after withdrawal from the business of the decedent would not preclude availability of the installment payment provision for the decedent's estate.

The bill would eliminate the present law difference in treatment of certain nonbusiness assets owned by partnerships and corporations as compared to those assets owned by individuals carrying on businesses as proprietorships. The bill would apply the present rule for proprietorships to all businesses where assets were contributed to the business by or on behalf of the decedent and were not used in the conduct of the business throughout the one-year period ending on the date of the decedent's death. Therefore, under the bill, these nonbusiness assets would not be included in determining whether the decedent's interest in the business satisfied the requirement that 20 percent or more of the total interests in a partnership or 20 percent or more of the stock in a corporation (i.e., the percentage tests) be included in the decedent's gross estate.

Attribution rules

The bill would combine the automatic and elective attribution rules of present law and would eliminate the penalties that apply under the present elective attribution rules. The new attribution rules would apply to both the numerical tests and percentage tests for determining whether partnerships and corporations are closely held businesses. In addition, the definition of family member (i.e., persons whose stock or partnership interests are treated as owned by the decedent) would be expanded to include spouses of brothers, sisters, and lineal desendants of the decedent as well as estates of family members. The broader attribution rules would normally increase the value of the business interest treated as owned by the decedent for purposes of determining whether his or her estate qualified under the installment payment provision.

Aggregation rules

The bill would expand the present law rules under which interests in multiple businesses are aggregated to qualify for the installment payment provision. Under the bill, interests which satisfy either the numerical test or the percentage test for determining whether the business is a closely held business could be aggregated to meet the requirement that an interest in a closely held business equal at least 35 percent of the decedent's adjusted gross estate. This aggregation would be permitted only if the value of each such business comprised at least 5 percent of the value of the decedent's adjusted gross estate. Thus, an estate could aggregate interests in a maximum of 20 businesses to qualify for the installment payment provision.

Definition of trade of business

The bill would expand the types of assets that, in combination, constitute a trade or business under the installment payment provision to include interests (stock, partnership interests, and indebtedness) in passive holding companies to the extent that the holding company assets represent interests in active businesses which would meet the requirements of the provision if owned directly.

The bill would also expand the availability of the installment payment provision for estates owning interests in oil and gas ventures. Under the bill, if an income tax election to treat co-owners of an oil and gas lease as proprietors were in effect at the decedent's death (under sec. 761(a)), the co-owners would be treated as proprietors for estate tax purposes as well.

Two other exceptions to the active business requirement would be enacted by the bill. First, the bill would treat royalty interests in oil and gas ventures as interests in closely held businesses regardless of whether these interests are essentially passive investment assets. Second, the bill would treat assets owned by the decedent that are passively leased to a closely held business in which the decedent was a partner or shareholder as interests in such a business.

Expansion of acceleration exceptions

The bill would expand the present law situations in which an interest in a closely business can be disposed of, and in which property can be withdrawn from the business, during the extended payment period without accelerating the payment of deferred estate tax. These expanded exceptions would apply to estates of individuals who died before 1982 if the estates elected the benefits of former section 6166A as well as to all estates electing the present installment payment provision.

Dispositions and withdrawals to pay death taxes and estate expenses

The present rule under which certain redemptions of stock from a corporation solely to pay Federal estate taxes are not treated as dispositions or withdrawals under the acceleration rules would be amended to extend this rule to any disposition or withdrawal of funds of an interest in a closely held business (whether or not by means of a redemption under sec. 303) to the extent that the proceeds are used to pay any death taxes resulting from the decedent's death (including, but not limited to, Federal estate taxes) and also funeral and administration expenses (including interest on the deferred tax) allowable to the estate as an estate tax deduction. Thus, the exception would apply to proprietorships and partnerships as well as corporations and would permit interests in the business to be sold to third parties as well as redeemed by the business entity. In addition, the bill would delay the date by which the tax would have to be paid following the disposition in the case of dispositions occurring during the first 5 years of the extended payment period. In such cases, payment of the taxes or expenses would not have to be made until the due date of the first installment of tax. Therefore, estates could dispose of stock in a closely held business up to 5 years before the proceeds of the disposition were used for payment of death taxes or funeral or administration expenses.

Reorganizations

The bill would expand the present exception to the acceleration rules for certain corporate reorganizations and stock distributions to include additional types of reorganizations (under sec. 368(a)(1)) and also tax-free exchanges of common stock for preferred stock in the same corporation (under sec. 1036).

No acceleration on subsequent death

The bill would expand the present exception to the acceleration rules for dispositions to a family member by reason of death of the heir receiving the decedent's closely held business property to permit such transfers without acceleration of unpaid tax whether or not the transferee is a family member.

No acceleration in case of certain buy-outs

The bill would enact a new exception to the acceleration rules for certain dispositions of interests in and withdrawals of funds from closely held partnerships and corporations if a note, rather than cash, is received. Under the new exception, the heir receiving the decedent's closely held business interest would be treated as disposing of the interest only to the extent that the value of the surrendered stock or partnership interest exceeded the face value of the note. The exception would only be available for exchanges where the note is (1) given by the corporation or partnership, or (2) where the note is given by another shareholder, partner, or an employee, and the purchaser had been a shareholder, partner, or employee of the business at all times during the one-year period before the exchange. If the purchaser were a shareholder or employee, the corporation or partnership would be required to guarantee the note. The bill would include special rules to accelerate unpaid tax if the note became readily tradable, were surrendered, or if 50 percent or more of the value of the business were acquired by a corporation whose stock was readily tradable.[38]

Involuntary conversions

The bill would provide that, in the case of an involuntary conversion, an interest in closely held business property is not considered to be disposed of to the extent that qualified replacement property is acquired.

Like-kind exchange

The bill would provide that, in the case of a like-kind exchange, an interest in closely held business property is not considered to be disposed of to the extent that the exchange is not taxable for income tax purposes (under sec. 1031).

Interest on installment payments

Under the bill, the special 4-percent interest rate would continue to apply to the first $345,800 (minus the amount of the decedent's unified credit) of estate tax extended under the installment payment provision. However, the rate on extended amounts in excess of the amount subject to the 4-percent interest rate would not accrue interest at the rate otherwise applicable to deficiencies (currently 16 percent). Under the bill, extended amounts in excess of this 4-percent portion would accrue interest at a rate equal to the average yield to maturity, of 14-year United States obligations, during the month of December preceding the year of the decedents' death.[39]

The bill would also change the manner in which the interest on installment payments is deducted for estate tax purposes. Under the bill the full amount of interest anticipated to be paid over the 14-year extended payment period would be deductible when the decedent's estate tax return was filed (even though the interest was not paid at that time). The amount of this deduction would not be discounted to reflect the fact that the interest were not presently payable. If the installment payment election was terminated before expiration of the 14-year extension period, the estate would recompute the deduction for interest, and its estate tax, at the time of the termination.

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[38] Readily tradable stock or notes would be stock or notes which there was a market on any stock exchange or in any over-the-counter market.

[39] At the present time, the Treasury Department has no obligations maturing in the month of December. Long-term obligations are normally issued in January with maturity dates of February 15, May 15, August 15, or November 15.

Declaratory judgment relating to installment payment provision

The bill would provide a procedure for obtaining a declaratory judgment with respect to—

(1) an estate's eligibility for extension of tax under the installment payment provision, or

(2) whether there is an acceleration of unpaid tax.

The declaratory judgment provision would only be available when there is an actual controversy; therefore, no declaratory judgment would be available before the decedent's death (with respect to eligibility for the extension) or before a transaction causing a potential acceleration of unpaid tax.

Jurisdiction to issue the declaratory judgment would be in the Tax Court, and the decision of the Tax Court would be reviewable in the same manner as other decisions. Collection of tax would be stayed until after a decision was rendered by the Tax Court, but the executor (or heir in the case of a dispute over acceleration of unpaid tax) would be required to pay the tax or post bond before appealing from the Tax Court. The bill would also permit the courts to impose penalties in the case of actions brought primarily for delay and where it was determined that the estate was not eligible for the extension provided by the installment payment provision or that the tax was properly accelerated.

Effective Dates

The provisions of the bill would apply generally to estates of individuals dying after December 31, 1981.

The provisions of the bill relating to acceleration of unpaid tax would apply to dispositions and withdrawals after December 31, 1981.

The provisions of the bill amending the rate of interest charged on installment payments and the estate tax deductibility thereof would apply to estates of individuals dying after December 31, 1981, and also—

(1) in the case of the rate of interest charged on installment payments, to tax outstanding on January 1, 1982, for an estate for which a timely election was made under either section 6166 or section 6166A, if the executor elects to have the amendment apply; and

(2) in the case of the rules on the estate tax deduction of interest on installment payments, to tax estimated to accrue after December 31, 1981, for an estate for which a timely election was made under either section 6166 or section 6166A, if the executor elects to have the amendment apply.

Elections to have these amendments apply could be made even though the estate had elected previously to claim the interest as an income tax deduction.

The declaratory judgment provisions of the bill would apply generally to estates of individuals dying, and to dispositions or withdrawals of business interests, after December 31, 1982. The provisions of the bill authorizing penalties in the case of certain declaratory judgment proceedings, and appeals from Tax Court decisions, would apply after the date of enactment.

Revenue Effect

It is estimated that this bill would reduce Federal budget receipts by $520 million in fiscal year 1984, $568 million in 1985, $621 million in 1986, $807 million in 1987, and by $1,097 million in 1988.

H. S. 1252—Senator Symms

Repeal of the Generation-Skipping Transfer Tax

Present Law

Under present law, a tax is imposed on generation-skipping transfers under a trust or similar arrangement upon the distribution of the trust assets to a generation-skipping heir (for example, a great-grandchild of the grantor of the trust) or upon termination of an intervening interest in the trust (for example, termination of a life income interest in the trust held by the grantor's grandchild).

Basically, a generation-skipping trust is one which provides for a splitting of benefits between two or more generations that are younger than the generation of the grantor of the trust. The generation-skipping transfer tax is not imposed in the case of outright transfers to younger generation heirs or to a trust if the benefits are not split between two or more younger generations. Thus, no generation-skipping transfer tax is imposed upon a "generator-jumping" or "layering" transfer directly to the grantor's grandchildren or other lower generation heirs. In addition, the tax is not imposed if the younger generation heir has (1) nothing more than a right of management over the trust assets or (2) a limited power to appoint the trust assets among the lineal descendants of the grantor. Present law also provides a grandchild exclusion for the first $250,000 of generation-skipping transfers per deemed transferor that vest in the grandchildren of the grantor.

The tax is substantially equivalent to the tax which would have been imposed if the property had been actually transferred outright to each successive generation (in which case, the gift or estate tax would have applied). For example, assume that a trust is created for the benefit of the grantor's grandchild during the grandchild's life, with remainder to the great-grandchild. Upon the death of the grandchild, the tax is determined by adding the grandchild's portion of the trust assets to the grandchild's estate and computing the additional tax at the grandchild's marginal estate tax rate. In other words, for purposes of determining the amount of the tax, the grandchild would be treated under present law as the "deemed transferor" of the trust property.

The grandchild's marginal estate tax rate is used for purposes of determining the tax imposed on the generation-skipping transfer, but the grandchild's estate is not liable for the payment of the tax. Instead, the tax is generally paid out of the proceeds of the trust property. In determining the amount of the generation-skipping transfer tax arising after the death of the deemed transferor, the trust is entitled to any unused portion of the grandchild's unified transfer tax credit, the credit for tax on prior transfers, the credit for State death taxes, and a deduction for certain administrative expenses.

A transitional rule was included in the law for generation-skipping transfers occurring pursuant to revocable trusts or wills in existence on June 11, 1976, if the instrument was not amended after that date to create or increase the amount of a generation-skipping transfer, and if the grantor or testator died before January 1, 1983. Generation-skipping trusts that were irrevocable on June 11, 1976, are not subject to the tax.

Issue

The issue is whether the tax on generation-skipping transfers should be repealed.

Explanation of Provision

The bill would repeal the generation-skipping transfer tax.

Effective Date

The bill would apply to otherwise taxable generation-skipping transfers occurring after June 11, 1976. Refund claims with respect to such transfers would be required to be filed within two years after the date of the bill's enactment.

Revenue Effect

It is estimated that the bill would reduce Federal budget receipts by $5 million dollars annually in fiscal years 1984 to 1988. The long term effect of the bill would be to reduce budget receipts by approximately $280 million.

I. S. Res. 126—Senators Wallop, Boren, Symms, Durenberger, Grassley, Bentsen, Dole, Roth, Baucus, and others

Expressing Sense of the Senate That Scheduled Reductions in Estate Tax Should Not Be Modified

Present Law

The Economic Recovery Tax Act of 1981 (ERTA) modified the gift and estate tax laws in numerous significant ways. ERTA increased the unified credit (which determines the amount of property that can be transferred without gift or estate tax) to an equivalent amount of $600,000, and (phased in over 6 years) and reduced the maximum tax rate from 70 percent to 50 percent (phased in over 4 years). An unlimited marital deduction was provided and certain terminable interests became eligible for the deduction for the first time. The gift tax annual exclusion was increased from $3,000 to $10,000 per donee. Rules governing the installment payment of estate tax attributable to interests in closely held businesses and the current use valuation of certain real property were liberalized.

Finally, ERTA made a number of other modifications to the gift and estate tax rules, including repeal (for most purposes) of the rule that gifts made by a decedent within three years of death must be included in the decedent's gross estate; elimination of a step-up in basis if appreciated property is acquired by gift by the decedent within one year of the decedent's death and then is returned to the donor or the donor's spouse; repeal of the orphan's exclusion; annual filing of gift tax returns; one-year extension of the transitional rule for certain wills or revocable trusts under the tax on generation-skipping transfers; and allowance of a charitable deduction for gift and estate tax purposes for certain bequests or gifts of copyrightable works of art, etc., when the donor retains the copyright.

As indicated above, the increase in the unified credit and the reduction in the maximum rate are being phased in. Specifically, the unified credit was increased by ERTA as follows:

Year	Unified credit	Equivalent amount
1982	$62,800	$225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987	192,800	600,000

The maximum rate was reduced as follows:

Year	Maximum rate (percent)
1982	65
1983	60
1984	55
1985	50

Issue

Some persons have suggested that if tax increases are enacted in 1983, Congress should "freeze" reductions scheduled to become effective after 1983 rather than enact other new increases while permitting those reductions to become effective. The issue is whether the 1981 estate tax reductions should be modified if taxes are increased in 1983 by freezing or modifying scheduled future reductions in general.

Explanation of Provision

The resolution would express the sense of the Senate that gift and estate tax reductions enacted in 1981 are vital to the continuation of family farms and small businesses and that the reductions scheduled to become effective after 1983, should not be modified or repealed.

IV. DESCRIPTION OF OTHER MATTERS

A. Treasury Department Proposal on the Generation-Skipping Transfer Tax

Present Law

Overview

Present gift and estate tax rules do not apply where an individual has only an income interest or a special power of appointment in a trust, if the individual is not the grantor of the trust. Consequently, the present gift and estate tax rules allow a parent to provide his or her children with most of the beneficial interest over a trust through an income interest and a special power of appointment without the children being subject to gift and estate taxes. In substance, these rules permit the gift and estate taxes of the children's generation which are attributable to the value of the trust to be "skipped".

In order the prevent this result, Congress enacted a generation-skipping transfer tax as part of the Tax Reform Act of 1976. The generation-skipping transfer tax applies only where the beneficial ownership of the trust is shared by two or more generations younger than the generation of the grantor of the trust. The generation-skipping transfer tax essentially is equal to the additional gift and estate taxes that the otherwise "skipped" generations would have paid if the property were given outright to them.

Generation-skipping trust

The generation-skipping transfer tax applies to a generation-skipping trust or a trust equivalent. A generation-skipping trust is one which has beneficiaries in two or more generations younger than the generation of the trust's grantor (e.g., the grantor's children and grandchildren). An individual is considered a beneficiary of the trust if he or she has either an interest in the trust or a power over the trust property. Under a special exception, an individual is not considered a beneficiary of the trust because of a power to allocate trust assets solely among the individual's lineal descendants.

The determination of the generation to which an individual belongs generally follows family relationships from the grandparents of the grantor. Where a beneficiary of the trust is not related to any family member of the grantor's grandparents, that beneficiary is assigned to a generation based upon the difference in ages between the beneficiary and the grantor.

Taxable event

The generation-skipping transfer tax is imposed when either a "taxable termination" or a "taxable distribution" occurs with respect to the generation-skipping trust.

A taxable termination occurs where there is a termination of an interest or power held by an individual in a generation younger than that of the grantor (e.g., the death of the grantor's child who had an income interest in the trust) and individuals in even a lower generation (e.g., the grantor's grandchildren) have an interest or power in the trust.

A taxable distribution is a distribution out of the generation-skipping trust of property (other than accounting income) to an individual who is in a generation at least two generations below that of the grantor, but only if another person in a younger generation than that of the grantor is also a beneficiary (e.g., a distribution to the grantor's grandchildren from a trust of which the grantor's children are also beneficiaries of the trust). Distributions of trust accounting income generally are not treated as taxable distributions. Thus, distributions of accounting income to the grantor's grandchildren are not treated as taxable distributions. However, when there are distributions of both income and corpus within the same taxable year of the trust, the income is treated as being distributed first to the older generation beneficiaries (e.g., distributions to the grantor's children are deemed to be made first from accounting income).

Determination of generation-skipping transfer tax

The generation-skipping transfer tax is the additional gift or estate tax that the "skipped" generation (i.e., the "deemed transferor") would have paid if the trust property had been given directly to the deemed transferor instead of the generation-skipping trust. The deemed transferor generally is the parent of the person who benefited from the taxable termination or taxable distribution (e.g., the child of the grantor).[40] The statute provides a special exemption under which no generation-skipping transfer tax is imposed on transfers that vest property in the grandchildren of the grantor up to $250,000 per deemed transferor.

The additional gift or estate tax that the deemed transferor would have paid is equal to the gift or estate tax that the deemed transferor would have paid had the value of the property in the generation-skipping trust been included in his or her taxable gifts or taxable estate over the actual gift or estate tax that was imposed with respect to the deemed transferor. The statute and the legislative history of the generation-skipping transfer tax anticipated that the Internal Revenue Service will provide such information concerning the gift and estate tax history of the deemed transferor as is necessary to compute the generation-skipping transfer tax.

Effective date

The present tax on generation-skipping transfers applies to generation-skipping trusts created pursuant to transfers made after June 11, 1976. However, the tax does not apply to transfers made pursuant to generation-skipping trusts created pursuant to wills (or revocable trusts) executed on or before June 11, 1976, if the will or trusts were not amended after that date and the testator or grantor died before January 1, 1983.

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[40] If, however, the parent is not or was not a beneficiary of generation-skipping trust, but there is another ancestor of the beneficiary who is also in a younger generation than that of the grantor and who is related by blood to the grantor, the youngest of such ancestors is the deemed transferor.

Description of Treasury Department Proposal

Overview

The Treasury Department proposal [41] would replace the existing generation-skipping transfer tax, which attempts to determine the additional gift and estate tax that would have been paid if the property had been transferred directly from one generation to another, with a generation-skipping transfer tax determined at a flat rate.

Transfers of each grantor would be exempt from the generation-skipping transfer tax up to $1 million. The generation-skipping transfer tax would be expanded to include direct generation-skipping transfers (e.g., a direct transfers from grandfather to grandchildren) as well as those in which benefits are "shared" by beneficiaries in more than one benefits are "shared" by beneficiaries in more than one younger generation.

Flat rate of tax

Under the Treasury Department proposal, the rate of tax on generation-skipping transfers would be 80 percent of the highest gift and estate tax rates. Thus, the rate of tax on generation-skipping transfers would be 48 percent in 1983, 44 percent in 1984, and 40 percent in 1985 and thereafter.

$1 million exemption

Under the Treasury Department proposal, an exemption would be provided for all generation-skipping transfers pursuant to transfers of each grantor of up to $1 million. In addition, an individual could use the exemption of his or her spouse with that spouse's consent. The exemption would be claimed on the gift or estate tax return which reported the transfer creating the generation-skipping trust. Once a transfer was designated as exempt, all subsequent appreciation in value of the transferred property would also be exempt. The $1 million exemption would replace the $250,000 grandchild exclusion of present law, but wold not be limited to transfers to grandchildren of the grantor.

In addition, the generation-skipping transfer tax would not apply to any inter-vivos transfer which is exempt from gift tax pursuant to the $10,000 annual exclusion.

Direct generation-skipping transfers

Under the Treasury Department proposal, the generation-skipping transfer tax would apply to direct transfers from individuals of one generation to individuals who are two or more generations younger than the transferor (e.g., a direct transfer from grandfather to grandchildren or great-grandchildren). However, only one direct generation-skipping tax would be imposed on a particular transfer (e.g., a transfer from grandfather to great-grandchildren would be subject to only one generation-skipping transfer tax even though the transfer skips two generations).

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[41] The Treasury proposal was submitted to Congress in the form of a memorandum that accompanied a letter, dated April 29, 1983, from John E. Chapoton, Assistant Secretary for Tax Policy, to Senator Symms.

Computation of tax

In the case of a direct generation-skipping transfer, the amount subject to the generation-skipping transfer tax would be the amount received by the beneficiary. In all other cases, the amount subject to tax is the full amount transferred, including any amounts out of which the generation-skipping transfer tax was paid.

Income exception

The exemption of present law from the generation-skipping transfer tax for distributions of accounting income would be eliminated.

Effective Date

Under the Treasury Department proposal, the revised generation-skipping transfer tax would apply to all transfers from irrevocable trusts created on or after the date of enactment of the proposal and to all direct generation-skipping transfers made on or after that date. However, the revised generation-skipping transfer tax generally would not apply to transfers pursuant to wills of decedents dying no more than one year after the date of the proposal's enactment.

B. Relationship of Federal Unlimited Marital Deduction to State Death Taxes

Before enactment of the Economic Recovery Tax Act of 1981 (ERTA), a deduction was allowed in determining the amount of the Federal estate tax for certain transfers to the surviving spouse of the decedent. This deduction generally could not exceed 50 percent of the adjusted gross estate of the decedent (Code sec. 2056). ERTA removed the 50 percent limitation applicable under prior law; thus, an unlimited marital deduction is permitted under present law.

Under the rules both before and after ERTA, no marital deduction is allowed for amounts paid as State death taxes, even though the State death taxes are imposed with respect to amounts passing to a surviving spouse.

Under the law both before and after ERTA, a limited credit is allowed against the Federal estate tax for State death taxes (sec. 2011). The amount of the State death tax varies with the size of the Federal taxable estate. The size of the credit varies from 0.8 percent for taxable estates from $0 to $90,000 to 16 percent of a taxable estate over $10,000,000.

A number of States impose inheritance taxes, estate taxes, or both on their citizens. In addition, a number of these States have not modified their tax laws to provide for exemption for unlimited amounts transferred to a surviving spouse or did so with a different effective date from that in ERTA.[42] As a result, it is possible that a State would impose some death taxes in the case where all of the decedent's property is transferred to his or her surviving spouse. Since State death taxes are not deductible for Federal estate tax purposes, it is possible that, in such cases, there will be a taxable estate for Federal estate tax purposes and some Federal estate tax will be due. Moreover, since Federal estate taxes are not deductible for Federal estate tax purposes, the Federal estate tax arising from the State death taxes may give rise to additional Federal estate tax (e.g., an interrelated computation may be necessary to determine the tax in such cases).

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[42] The unlimited marital deduction provided by ERTA became effective for estates of individuals dying, and gifts made, after December 31, 1981.

C. Modification of Current Use Valuation Rules

Maximum reduction in value

If certain requirements are satisfied, present law permits real property used in family farming operations and other closely held businesses to be included in a decedent's gross estate at its current use value, rather than its full fair market value, provided that the gross estate may not be reduced by more than $750,000 (Code Sec. 2032A). Before enactment of ERTA, the maximum permitted reduction in value was $500,000.

Special rules for specially valuing standing timber

Real property devoted to growing timber is treated as used for a farming purpose under the current use valuation provision. Unlike other growing crops which must be valued for estate tax purposes at their full fair martket value, standing timber can be specially valued as part of the land on which it grows. If specially valued timber is servered or disposed of during the regular 10-year recapture period applicable to specially valued property, the land upon which the timber stood is treated as having been disposed of and the special "additional estate tax" or "recapture tax" is imposed on the qualified heir. In the case of a partial disposition of specially valued timber, the proceeds received are recaptured up to the amount of tax that would be due if the disposition were of the underlying land.

PREPARED STATEMENT OF SENATOR SYMMS

Good morning. I would like to welcome all of you to the Committee this morning to discuss a matter that has been of continuing concern and interest to me—estate gift tax reform.

As all of you know, it is my policy goal to repeal estate and gift taxes because in my opinion, the estate and gift tax laws produce complexities in the estate planning; encourage disposition of assets contrary to the best interest of taxpayers, beneficiaries, and the economy; and work gross inequities among taxpayers.

Furthermore, Americans who acquire and hold property express themsleves in the way they deal with it: using it, spending it, saving it, giving it away. The social order around us tends to honor our choices in the basic theory that private decision-making is better than public control. To hold property and to have wide discretion over it are closely associated with our concepts of freedom.

Examined in an economic perspective, the right to transfer property has the positive values of fostering incentives in the form of rewarding industry, ingenuity and creativity, encouraging capital formation through saving and investment, permitting continuity of ongoing enterprise, and supporting diversity in priorities.

However, the realities of the current day dictate that repeal is not possible at this time because of the fiscal implications on the Budget and the deficit. As a result, it is important that we carefully review the problems that certain portions of our estate tax law impose on taxpayers to correct inequities so that while the tax is in place, taxpayers will be able to comply with the law without the burden of estate taxes causing severe economic dislocations.

I look forward to the testimony this morning * * *

PREPARED STATEMENT OF SENATOR CHARLES GRASSLEY

Mr. Chairman, I would like to commend you for holding this hearing on a series of important estate tax bills. Many of the issues before the subcommittee today have been recurring trouble spots in the estate tax portion of the Internal Revenue Code.

The timing of this hearing is particularly important. Since the Congress just agreed to a budget resolution calling for $73 billion worth of revenue increases over the next three years, the tax writing committees will be compelled to look through the Code for ways to save revenue. The Chairman of the House Ways and Means Committee has suggested that an appropriate place to begin looking is in the estate and gift tax provisons adopted by Congress in the Economic Recovery Tax Act of 1981. Senator Symms has wisely scheduled this hearing to create a record demonstrating exactly why such an action is unacceptable.

In the Economic Recovery Act of 1981, Congress enacted an increase in the unified credit from $47,000 to $192,000 over a five-year period. The unified credit is an offset against estate tax liability; consequently, a credit of $47,000 permits the first $175,000 of an estate to pass to beneficiaries tax free this year, a $325,000 estate to pass tax free in 1985, a $500,000 estate to pass tax free in 1986 and a $600,000 estate to pass tax free in subsequent years.

The $600,000 federal estate tax exclusion is crucial to many of my constituents. The average size of an Iowa farm in 1982 was 294 acres, according to the Iowa Department of Agriculture's Iowa Crop and Livestock Reporting Service. Iowa State University's Cooperative Extension Service tabulates the average value of farmland by acre. In 1981, the average per acre value of Iowa farmland was $2,147, in 1982 it fell to $1,801 per acre. These statistics show that the average Iowa farm in 1982 was worth $529,494. With the exclusion of $225,000 in 1982, the average Iowa farm had a taxable value for estate tax purposes, given no other adjustments, of $304,000.

These numbers portray the average farmer. These individuals have earned little during their lives and hope to pass the family farm on to their children. In the past, our estate tax laws were a major obstacle in accomplishing this goal. Based on the foregoing averages, the average Iowa farmer's estate will owe the Treasury $89,160 upon his death once the exclusion is applied which was added in ERTA. Most Iowa families have a very difficult time paying a $90,000 tax bill on an average net farm income of $15,845.

The increase in the estate tax exclusion should be retained, but other areas within the estate tax portion of the code have caused harsh results for many taxpayers. The subcommittee is examining legislation to correct some of these problems. The testimony of the witnesses will be helpful to all of us in assessing which areas are most in need of reform. Their comments will assist all of us in setting priorities in the estate tax area and increasing our resolve to fight any limitation of the ERTA provisions.

Senator SYMMS. Good morning. I would like to welcome all of you to the committee this morning to discuss the matter that has been a continuing interest and concern to me; that is, estate and gift tax reform.

As all of you know, it has been my policy to repeal estate and gift taxes because in my opinion, the estate and gift tax laws produce complexities in estate planning, encourage disposition of assets contrary to the best interests of the taxpayers, the beneficiaries, and the economy, and work gross inequities among taxpayers.

Furthermore, Americans who acquire and hold property express themselves in the way they deal with it—using it, spending it, saving it, giving it away, and the social order around us tends to honor our choices in basic theory that private decisionmaking is better than public control. To hold property and to have wide discretion over it are closely associated with the concepts of freedom.

Examined in an economic perspective, the right to transfer property has the positive values of fostering incentives in the form of rewarding industry, ingenuity, creativity, encouraging capital formation through saving and investing, and permitting continuity of ongoing enterprise and the supporting diversity and priorities.

However, the realities of the current day dictate that repeal is not possible at this time because of the fiscal implications on the budget and the deficit. As a result, it is important that we carefully review the problems that certain portions of our estate tax law impose on taxpayers to correct inequities so that while the tax is in place, taxpayers will be able to comply with the law without the burden of estate taxes causing severe economic dislocations.

I might just say that in my opening comments, my attitude about why I think that the estate and gift tax or the death tax should be repealed, I think there probably is no single thing that symbolizes the difference between the United States and our adversaries, the Soviet Union, than the very essence of private property and private property ownership.

The estate and gift tax causes all kinds of bad decisions to be made by small business primarily, which is the backbone of America's business, where people try to make decisions so that they don't have to buy the farm twice, or buy the small business twice, the first time buying it and the second time the members of the family buying it again when someone dies. And the application of the death tax and the fear of it causes people to not invest capital for real long-term growth in this country because of the concern that they won't be able to give it away, and I think that the proper position, if we believe in capital formation and supply side economics, should be to outright repeal the estate and gift tax.

But since we can't do that, we are going to try to do the things that many of you will be here testifying today. Hopefully we will be able to do it at some point in time, but I might just say that we are looking forward to having all of the testimony of the many witnesses we have here today incorporated into our record. So as we move on through the hearings today, we would like to be able to—we have some 25 plus witnesses and we are going to try to just continue to run the clock and some other Senators will be here, hopefully, to spell the chair off occasionally so we can keep the hearing process going.

So, to expedite the hearing, your entire statements will be made a part of our record, which is important, so that when we come to the opportunity of offering amendments to any revenue bill that happens to be before the Finance Committee, that we will have had the opportunity to have the benefit of your testimony and the hearing process will be completed. We would like to have a complete record. There may be questions that we would like to ask that we may submit in writing. Particularly we will probably do that with Treasury, so that we won't have to delay the proceedings here this morning.

So, our first witness this morning is Mr. Robert Woodward, Acting Tax Legislative Counsel, Department of Treasury, Washington, D.C. Bob, welcome to the committee and please go right ahead.

STATEMENT OF ROBERT G. WOODWARD, ACTING TAX LEGISLATIVE COUNSEL, DEPARTMENT OF TREASURY

Mr. **Woodward**. Thank you, Mr. Chairman. I am pleased to have the opportunity to present the views of the Treasury Department on the estate and gift tax matters before the subcommittee today. We have a rather lengthy written statement for the record, which I will attempt to summarize briefly in my oral remarks.

Our statement first discusses the policy issues raised by Senate Resolution 126, which expresses support for the estate and gift tax reductions enacted in the Economic Recovery Tax Act of 1981 that are scheduled to take effect after 1983; and S. 1250, your bill, which would repeal the estate and gift taxes.

This administration has repeatedly expressed its concern over the disincentives to savings and capital formation caused by excessive estate and gift taxes. To reduce these undesirable economic effects, we strongly supported the lowering of the top estate and gift tax rates, the increase in the unified credit, the enactment of an unlimited marital deduction, and other estate and gift tax reforms made in ERTA. ERTA phased in the lowering of the top estate and gift tax rate and the increase in the unified credit over a number of years, primarily because of revenue constraints. Many taxpayers have taken these estate and gift tax reductions that are scheduled after 1983 into account in their current planning.

More importantly, the reasons for enacting the estate and gift tax reductions in ERTA have not changed. Thus, the administration fully supports Senate Resolution 126, which expresses the sense of the Senate that the estate and gift tax reductions enacted in ERTA should remain undisturbed.

S. 1250 raises the important question of whether the estate and gift tax reductions enacted in ERTA went far enough. Even after these reductions, valid arguments can be made in support of repeal of the estate and gift taxes in their current form. Nevertheless, the taxes will raise nearly $6.1 billion in fiscal year 1983 and nearly $5.9 billion in fiscal year 1984. In view of the current budget deficits, we think it is unrealistic to consider the elimination of this revenue.

Thus, instead of repealing the estate and gift taxes, our short-term goal should be to make the current estate and gift tax system operate more fairly and rationally.

I will now discuss S. 1250, which would repeal the generation-skipping transfer tax, and the Treasury Department's proposal to simplify and improve that tax.

In November of 1981 the Treasury testified before this subcommittee on S. 1695, a proposal in the 97th Congress that is identical to the current proposal in S. 1252 to repeal the generation-skipping transfer tax imposed by chapter 13 of the Internal Revenue Code. At that time we stated our opposition to the repeal of chapter 13, but we went on to suggest a number of ways in which the generation-skipping transfer tax might be simplified and improved.

We also stated that we were studying additional ways to simplify chapter 13 without compromising its underlying purpose. Our study culminated in the release on April 29 of this year of a proposal for a new and fundamentally different generation-skipping transfer tax. This proposed new tax would be simpler than the present tax and would affect the estate planning of a much smaller class of taxpayers. At the same time, it would be fairer and more effective than the present chapter 13. A copy of our April 29 proposal is attached to our written statement for your reference.

The proposal aims to achieve its objective by making three fundamental changes in the generation-skipping transfer tax system. First, every individual would be permitted to make transfers aggregating as much as $1 million during lifetime and at death, which would be wholly exempt from the generation-skipping tax. This would mean that, in general, a married couple could make up to $2 million of generation-skipping transfers without becoming subject to the tax.

Second, generation-skipping transfers not covered by the $1 million/$2 million exemption would be taxed at a flat rate equal to 80 percent of the highest estate tax rate in effect at the time of the transfer. This means that for taxable generation-skipping transfers after 1984, the tax rate would be 40 percent.

Third, the proposal would tax direct generation-skipping transfers to the extent they are not covered by the new $1 million exemption, as well as transfers through multigenerational trusts.

The details of our proposals are set forth in our April 29 release. I will not repeat them here, although I would be happy to answer any questions you might have regarding the proposal. I would like to use this opportunity primarily to discuss what I believe are some of the fundamental issues relating to the tax treatment of generation-skipping transfers.

In order to determine whether a tax on generation-skipping transfers is necessary, and if so, what form such a tax should take, it is first necessary to decide what is meant by the term generation-skipping transfer. There are essentially two schools of thought on this issue.

The first school of thought, which I will call the generation-sharing school, believes that a generation-skipping transfer is one which allows a beneficiary in a generation below the transferor to enjoy benefits of ownership in property without such property being included in his estate when it is ultimately transferred to or for the benefit of beneficiaries in an even lower generation.

The classic example of this type of generation-skipping transfer is a transfer of property in trust, with the child of the transferor receiving the income for life and the remainder going to the transferor's grandchildren at the child's death. The existing generation-skipping transfer tax statute deals only with this type of generation-skipping transfer.

The second school of thought, to which the Treasury belongs and to which I will refer as the broad-based school, believes that a generation-skipping transfer is any transfer of property to or for the benefit of persons two or more generations below that of the transferor without the payment of estate and gift taxes in the skipped generation, regardless of whether any person in the skipped generation had any ownership interest in the property.

This broad-based definition includes direct generation-skipping transfers, as well as transfers where a member of the skipped generation has an interest in or power over the property. Thus, a gift directly to the transferor's grandchildren, in trust or otherwise, is included in the broad-based definition of generation-skipping transfer.

As starting points, the generation-sharing and broad-based analyses may be equally valid. However, the generation-sharing approach leads to three fundamental problems that can be resolved only by shifting to the broad-based approach.

The first problem with the generation-sharing approach is that it is not neutral. Taxing generation-skipping transfers in generation-sharing trusts, while allowing direct transfers to the same ultimate recipients to pass free from additional tax discourages the use of generation-sharing trusts. This is socially undesirable, since there are many legitimate, nontax reasons for transferring property through generation-sharing trusts.

The second problem with the generation-sharing approach is that it is inequitable. A system which imposes an additional tax on generation-sharing trusts but does not tax direct generation-skipping transfers is biased in favor of the very wealthiest families, since the wealthiest families are in the best position to make substantial transfers directly to the grandchildren and great-grandchildren which skip their children's generations entirely.

The third problem with the generation-sharing approach is its inevitable complexity. The generation-sharing approach requires the determination of whether a member of a skipped generation, typically a child of the transferor, has an interest in a trust sufficient to make it a generation-skipping trust. The question of where to draw the line is a difficult one which inevitably leads to statutory and planning complexity. The broad-based approach avoids this complexity.

I would like to discuss each of these three considerations in greater detail. Our written statement does so, but in the interest of time I will skip over this portion of my testimony.

Senator SYMMS. Your entire statement is part of our record.

Mr. WOODWARD. We elaborate at some length on those three basic problems which we think argue compellingly in favor of a system that taxes direct generation-skipping transfers and not one that simply taxes transfers in which the interests in property are shared between two different generations.

Senator SYMMS. Well, is the Treasury then saying they want to substitute the estate tax with an accessions tax, so that you tax the person on how much they get, not from who they get it from?

Mr. WOODWARD. I don't think that our proposal goes in that direction, although I think that some have attempted to analyze our approach by reference to an accessions tax. I think, rather, it is premised on the notion that most families, in transferring property, are hit with this tax in every generation level.

Some families, however, the $50 million, $100 million and up estates in particular, don't need to give their children that amount of property. So they can jump over those children and go directly to the grandchildren. In those situations, for example, they can reduce the overall tax burden in their estates because the property is not needed in the intervening generation level.

That means that those families which for one reason or another need or want to give property to the intervening generation end up with a much higher effective rate of tax than do those estates in which the intervening generation is completely skipped.

We think that is inequitable. We think that any generation-skipping transfer tax system must acknowledge that there is a basic inequity if you don't tax direct generation-skipping transfers. And, therefore, we included the taxation of direct generation-skipping transfers in our proposal. And again, hold in mind it is only above the $1 million/$2 million exemption level at which this would ever apply. But once you are above that level, we think that it works a great inequity on the wealthy families, vis-a-vis the extremely wealthy families, if you don't tax direct generation-skipping transfers.

Senator **Symms**. Aren't you talking about taxing people at a rate of 70 percent, then?

Mr. **Woodward**. If you look at the effective rate of tax on successive transfers, in the very top brackets, the effective rate in passing property from a child and then again to a grandchild, if everyone along the line is at the top rate, would be 75 percent, and that is existing law.

Our proposal would tax that transfer at an effective rate of 70 percent. You are correct, but we think that in view of the fact that the regular estate tax would tax at 75 percent, we don't think that that is unreasonable.

Senator **Symms**. But Treasury has said, though, that the existing law doesn't work. They don't understand how to apply it. So that is really a little bit irrelevant, isn't it?

Mr. **Woodward**. I don't think that we have said that we don't understand how the existing law works, but I think we have noted that it does cause some administrative problems and that there is a broad perception among those who are affected by the tax that it is overly complex, and we acknowledge that.

We think, again, that the direct-transfer system that we are proposing, and the fact that we are imposing it on direct transfers, will result in a significant simplication of the existing tax. And I think that our proposal and our written statement go into some detail as to the reasons we believe that it does actually become simpler to take the broad-based approach.

Senator **Symms**. I will be happy to try to carefully study that and try to understand it, but it appears to me like you are taxing them twice. The estate tax, just to have a death tax in the first place is a double taxation because somebody in this system, we have these extraordinarily high tax rates in this country. So for people to get the estate in the first place, they pay taxes on the money to accumulate it, and then if they die, their family can buy it back from the Government again. Then they die and they do it again.

But it appears to me that what you are setting up would be that you do it twice.

Mr. **Woodward**. Again, Mr. Chairman, I think that the high tax rate that you are focusing on would apply only in those cases where very, very large transfers of property are made directly to grandchildren or great-grandchildren. There is a higher tax rate, combining the regular estate tax and the generation-skipping tax, but it is in recognition of the fact that once the property gets down to the grandchildren or the great-grandchildren, it will be a very long period of time before that tax will have to be paid again.

We can argue about the merits of taxing wealth, and we understand your position on that. Indeed, I think we have noted that there are very valid arguments that can be made about the adverse impacts of taxing accumulations of wealth. And this is something that we are studying. For example, we are looking at the consumption tax generally; we are studying the role of a wealth tax or transfer tax in that, and I think that those questions do need to be examined as a longer range project.

But as a shorter range matter, and in view of the revenue concerns, we are simply saying that a generation-skipping rule is a necessary part of any estate tax system simply to prevent those families who are supposed to be subject to this tax from having an easy means of avoiding it down the line and having a lower effective rate because they use this means of transfer on their overall family wealth.

My written statement goes into some detail in explaining the rationale underlying a number of other aspects of our proposal. The $1 million exemption is discussed in there and some of the reasons that we have for coming up with that figure. It is primarily designed as a means of eliminating from this generation-skipping system families of more modest wealth, in which cases generation-skipping poses much less of a problem in terms of the overall estate-and-gift-tax system.

We have contemplated that this exemption would be allocable between transfers by a married couple during their lifetime, although our April 29 memorandum does not go into the mechanics. We are certainly willing to work on our proposal to modify it to allow any individual to transfer any unused generation-skipping tax exemption at his death to his surviving spouse.

In general, our goal is to assure that a married couple with a combined estate of $2 million or less will be virtually free from the generation-skipping tax concerns that they now have in formulating their combined estate tax plan. We would be happy to work with all interested parties to formulate the approach which best assures that this will be the case.

We have a discussion in our written statement about the significance of a tax-avoidance motive. We argue, I think strongly, that the presence or absence of a tax avoidance motive in taxing generation-skipping transfers is really irrelevant, that the test should be whether a transfer has the tax avoidance effect in attempting to design a neutral and fair tax system.

A generation-skipping transfer, whether it is direct or through a generation-sharing trust, means that the property transferred will not be subject to estate or gift tax for two or more generations; and families which transfer their cumulative wealth in this fashion are thus paying a substantially lower aggregate lower estate and gift tax than families that transfer property directly from generation to generation, and we see no reason why a rational tax system should discriminate in favor of the very wealthiest families in this manner.

We also include in our written statement a discussion of the case of direct transfers to the children of a predeceased child of the transferor. We concede that an additional tax on a transfer to an orphan can appear harsh, but we don't believe, in view of the very large exemption level that we have, that it is necessary to provide a special rule to cover this kind of situation.

While the fact that a grandchild's parents are deceased may prove that a transfer was not motivated by tax avoidance, the transfer tax is avoided nevertheless in the intervening generation. We don't believe that the tax should be exempted simply because of the fortuitous circumstance of an unusual order of deaths.

We know that there is a valid argument in favor of a special rule for orphaned grandchildren in cases where the property would have been covered by a unified credit in the intervening generation. We question whether it is likely that many of these cases will, in fact, occur, but we are willing to take a look at a limited exception if necessary to deal with that sort of situation in which there might actually be a higher effective rate of tax because of the application of the generation-skipping tax.

But again, we have not included that in our proposal because we think that its complexity would probably outweigh the perceived gain in equity. But we are willing to study that question further.

Our written statement also discusses transfers which skip more than one generation. I might note that we do not propose a double generation-skipping tax on a transfer that skips more than one generation; that is, for example, a transfer to great-grandchildren. We do not propose to tax that more than once under the generation-skipping transfer tax. In other words, there is only one generation-skipping tax. If you tax a transfer to great-grandchildren, conceptually you could argue for two generation-skipping taxes because you are avoiding two rounds of estate tax rather than just one in that sort of a situation.

We have not included that, and we think our decision not to have an additional generation-skipping tax in those circumstances really reflects a reasonable balance of competing considerations. Some significant additional complexity would be imposed by assessing a double generation-skipping tax when you skip not one but two generations. We don't think that there will be that many of those kinds of cases that actually occur and the complexity that would be added to the statute to deal with that sort of situation, and the perceived hardship that could occur in certain cases, make it advisable not to include that in our proposal.

Finally, I want to emphasize that there is a need for prompt action concerning the generation-skipping tax, and I know that you will hear a great deal about that need from some of the witnesses that will come after me this morning.

Since the beginning of 1983, the generation-skipping tax has been fully in effect. Many individuals with pre-June 11, 1976, wills and revocable trusts are now faced with the question of whether these wills and trusts should be amended to take into account present chapter 13.

The legislative uncertainty has made estate planning in this area difficult. We believe that a clear statement of what the law will be is needed as soon as possible.

Senator SYMMS. May I ask you a question just on that point?

Mr. WOODWARD. Yes, Mr. Chairman.

Senator SYMMS. In view of the fact that you recognize that this is a very imperfect system that we are involved in right now, do you favor outright repeal of the present law until we can work up an answer on the proposal that Treasury has now come out with to clarify the situation for the people who are trying to solve their problems now?

Mr. WOODWARD. No, Mr. Chairman, and I would like to comment on that if I may. We know that many you will hear today will urge that course of action. We are indeed aware of and in fact are participating in the American Law Institute meetings and also talking with other groups that are currently studying the issue of generation skipping, but we do not think that Congress should pass outright repeal of the present chapter 13 without a new tax in its place.

We would urge instead that a statute based on our proposal be enacted as soon as possible, effective immediately for transfers that are made by gift but with a postponed effective date by 1 year for transfers that occur at or after the transferor's death. This will give the ability to modify existing instruments to take into account the existing tax.

Again, I know that there has not been a bill introduced. We have a somewhat very detailed proposal. We are at work in drafting a statute. Indeed, I have the first draft of it right here. I hope that, consistent with our other responsibilities in presenting testimony before congressional committees and dealing with what goes on in the next month, we do hope to have the statutory language out in the very near future, and indeed we are working actively on that.

Senator SYMMS. You can see what my concern is that this is a new proposal. It may have a lot of merit and there are a lot of questions about it, I am sure, and some that I have raised here this morning and there may be others.

The way things work around this town it could be 5 years before that is enacted into law, and if that is the case, what do we do for all the people that are trying to get their estates done for the next 5 years and cannot understand this law that is presently on the books? At some point here we need to get this thing finalized.

Mr. WOODWARD. Mr. Chairman, we agree with you wholeheartedly in that regard. I have expressed that view many times to the bar groups and others who have expressed the point of view of let's repeal it and then we will work on some alternative system at a more leisurely pace.

We all know the realities also that that more leisurely pace could end up being a very long period of time and we don't think that the system ought to be left without a generation-skipping rule for an extended period of time.

We, however, would hope very much that something will be done this year at the earliest possible moment, and I commend you for having scheduled these hearings to push the matter along because it is something that can get pushed aside in the rush to deal with a lot of other matters. I think we are in complete agreement with you that this ought not be pushed off for any significant additional period of time.

Senator SYMMS. Well, thank you very much. I might just say again that as complex and complicated as this is, and where it has proven to be such a complex area, I would hate it if we ended up enacting a new law and then we are back in here 2 years from now trying to repeal the new law, but you still have all of the estate planning in the whole country out there in a state of limbo.

So all that does is that we have that kind of an unpredictable situation; then the very goals of the Reagan administration, which are capital formation and real, noninflationary growth, are hurt because people get up to that age where they start thinking that they have lived two-thirds of their life, most likely, because one thing I can state in here unequivocably that will be correct is everybody in this room is going to die sometime.

So everybody has a tendency to spend—the economic incentive is to spend the money on consumption and not worry about real growth for the future, and it hurts the overall picture of the American economy to have millions and millions of economic decisions being made by individuals which lead to less economic growth instead of more economic growth, and it really denies opportunities to the people that are less well off than those people that are spending the money. They are the ones that end up getting hurt because they don't have the opportunities for the jobs.

I just think we are making a mistake here in terms of the overall picture of what the President's program is. I have talked to President Reagan personally about this. He says he is for repealing the death tax. His personal opinion is repeal the death tax. He thinks it is wrong; it is based on a socialistic principle; it is an anticapitalistic principle; it is antiprivate property; it is against every single thing in the American dream to go out here and tax some poor businessman or farmer, to tax his business away from him.

Now we make some tremendous strides if we can keep them in the books in 1981 law, which I commend Treasury and the administration for supporting, but some of these technical factors that aren't talked about much are very, very, I think, discriminatory against long-term economic growth in this country, and they are just pure and simple anticapitalistic, antiprivate property, socialistic, any kind of a word you want to put on it.

When you start talking about taxing somebody's estate at the 70 percent level, that is outright confiscation. That is not taxation; that is confiscating someone's life's work away from him. I think that it is just outrageous that we can't get rid of this, particularly when we have a President who agrees with the chairman on this subject. I mean, somehow or other there seems to be a lack of coordination between Treasury and President Reagan, and I thought he was supposed to be running the show.

Mr. WOODWARD. Mr. Chairman, he very definitely is, and I will assure you that the views we have expressed have been fully coordinated——

Senator SYMMS. We had better get EPA to check the water out at Treasury. [Laughter.]

It doesn't matter who they are, Democrat or Republican. They go down and start drinking that water and all they want to do is tax somebody's estate or tax their wealth or tax this, you know.

Mr. WOODWARD. I might add that there are a number of tax measures on the books that, if we had our way about it, would either eliminate or structure very differently. Unfortunately, we have a Congress that has found ways to spend lots of Federal revenues which we are under a duty to collect, and in so doing, we have to try to deal with the hand that we are dealt, in effect, and think that on generation skipping that is what we are attempting to accomplish.

I think that many of the statements that you have made, we have common ground on.

Senator SYMMS. I didn't mean to divert you. Please go ahead and proceed.

Mr. **Woodward**. I am now going to turn to the other bills before the hearing and discuss them very briefly.

Senator **Symms**. We have lots of witnesses this morning so move on, please.

Mr. **Woodward**. The first one is S. 1210, which would allow the election of the alternate valuation date on late-filed estate tax returns and would amend the alternate valuation date provision to deal with certain abuse cases.

We generally support the basic principles incorporated in S. 1210. However, we object to certain provisions of the bill as currently drafted. This bill deals with a problem that has been exacerbated by the increase in the unified credit and the unlimited marital deduction enacted in ERTA, and that is that there are many estates that may use the alternate valuation date to increase the income tax bases of property in the estate, where the decedent's property has appreciated in the 6 months after the date of death.

The alternate valuation date was originally intended to protect estates in cases where the property drastically declined in value in that 6-month period. The reason that this election can be used for income tax planning under current law is that in many cases, the increased unified credit and the unlimited marital deduction prevent any significant estate tax cost attributable to the higher estate tax valuation that would result in the cases where the property has gone up in value during the 6-month period after death.

We think that this is an unintended windfall for heirs who receive property that appreciates rapidly after the decedent's death. The bill represents an effort to deal with this problem. We strongly support that general thrust of the bill. We don't think that it goes far enough because of the fact that it excludes cases in which property subject to the marital deduction or charitable deduction is the property that has gone up in value, and we have in our written statement an example that illustrates this problem.

Thus, although we think the bill moves in the right direction, we think it would be preferable if the bill required that the entire gross estate, not just the nonmarital and noncharitable property, must decline in value before alternate valuation can be elected. We have suggested another approach that could be used to deal with that problem as well.

We also comment on the transitional rule in the bill that would permit certain late-filing estates to make retroactive elections to use the alternate valuation date within a year of the bill's enactment. We oppose that provision of the bill. It could provide a windfall to estates whose late-filed returns are open, by chance, at the date of enactment while denying relief to other estates where the returns are closed at the date of enactment, and that retroactive application of the changes made by the bill also would create administrative problems by requiring redeterminations of income tax bases of property.

The next bill is S. 1180, which would provide gift tax relief for certain disclaimers. The gift tax regulations published on November 15, 1958 provide that a refusal to accept ownership for property transferred to an individual constitutes a taxable gift by the individual who takes the property as a result of the refusal unless the refusal is made within a reasonable time after knowledge of the existence of the transfer. That regulation applies only to transfers before 1977 because of subsequent legislation.

In the case of the transfer of property in trust, the IRS position generally is that the transfer to the trust is the transfer that begins the running of the reasonable time period prescribed by the regulation. Thus, under the regulation, the trust beneficiary may make a tax-free disclaimer of his interest in the trust only if it is made within a reasonable period of time after the beneficiary learns of the creation of his interest in the trust.

The interpretation of that regulation has been the subject of litigation that has gone to the Supreme Court in the case of *Jewett* v. *Commissioner,* where the taxpayer argued that the reasonable time period for a trust beneficiary's disclaimer should begin only after the beneficiary's interest in the trust becomes vested.

The Supreme Court considered arguments which I think are essentially the same arguments that are made by the proponents of this legislation, and concluded not only that the taxpayers had no legal basis for contending for a different, more liberal construction of the regulation, but that their equitable arguments that the regulation had cut off some sort of a vested right to make tax-free disclaimers did not have merit.

This Supreme Court case had the effect of resolving a number of pending cases in favor of the Government, and those parties involved in those cases are now seeking relief in this bill, which would provide that relief and would provide a 90-day grace period for anybody in similar situations who, in effect, make a tax free gift by means of a disclaimer where he or she is in a position of receiving property from a trust in a case where the interest has not yet vested.

We strongly oppose S. 1180 for the reasons set forth in our statement. We think that the equitable arguments that are advanced in support of this bill were fully and adequately addressed by the Supreme Court in the *Jewett* case. We don't think that that decision ought to be overridden now by the Congress. We think those taxpayers involved in these cases simply took what I think should be considered a fairly aggressive position in estate planning. Many of them understood that their positions would be subject to attack, as they indeed have been subject. No doubt there are many estates in which the IRS might not have picked up on audit, but in those cases where they have, we think it would be an extremely bad precedent now for the Congress to enact retroactive private relief legislation.

The next bill before the hearing that I will discuss is S. 953 which would permit current-use valuation elections to be made on amended estate tax returns. The code currently allows an election to be made on the first estate tax return filed by an executor. That change permits filings on late returns, so long as it is the first return filed by the estate. That change was enacted in ERTA. Prior to the enactment of ERTA, the election had to be made on a timely filed return, taking into account any extensions.

This bill, S. 953, would permit estates to elect to use the current use valuation method on an amended estate tax return, and that change would be retroactive to all the estates covered by section 2032A of the code.

We oppose this bill. We think that the availability of current-use valuation under section 2032A will depend on facts and circumstances that are fully known to the executors of estates when the initial estate tax return is filed. We see no compelling reason why the time for making the election should be further deferred until the time for filing an amended return is passed.

Indeed, we think that this bill would encourage one type of noncompliance with the estate tax law. It would invite estates to value qualified real property on the first estate tax return at an amount that is unreasonably low, substantially below the fair market value, without making a 2032A election. By doing that, the estate would hope to avoid the provisions of section 2032A that require a recapture of the estate tax benefit in cases where the property is disposed of or ceases to be used for qualified purposes after the date of death.

If the bill were enacted, the executors would be allowed to go in with a very low value, below the fair market value, without electing 2032A with the knowledge that if challenged on audit, they could simply tell the revenue agent that they were going to file a 2032A election if he attempts to assert any estate tax deficiency, and we think that that is an undesirable impact.

Finally, we oppose the retroactive effective date of the bill. We think that Congress focused on the effective dates of a number of changes, including changes in this area, in ERTA, and we don't think that there's any strong reason that those decisions that were made in ERTA should be reversed at this point.

The next bill is S. 1251, the Section 6166 Technical Revision Act of 1983. This bill is in all substantial respects identical to S. 2479 which was introduced in the last Congress. It would make sweeping revisions in section 6166 of the Code, which provides for deferred payment of the estate tax when certain closely held business interests form a substantial portion of the estate.

We have previously submitted to the subcommittee our views on S. 2479. We had many reasons for opposing enactment of that bill. We noted, however, that the bill did identify some more technical aspects of section 6166 that we thought we could come to an agreement on concerning changes, but we opposed a piecemeal expansion of 6166 because it effectively does provide a very large significant estate tax reduction because it allows estate tax payment with a 4-percent interest rate for those estates that happen to qualify under that provision.

We think that works an inequity on estates that don't qualify because they are being taxed at a higher rate as compared to those with similar amounts of property that may be held in a different form. Our written statement on the bill from the last Congress is attached to our written statement for this hearing and it goes into some detail in discussing the various aspects of that bill.

The last bills that I will discuss are S. 309 and S. 310 which would provide special estate tax credits for the estate of Nell Redfield and the estate of Elizabeth Schultz Rabe. These bills would give those estates an estate tax credit for the conveyance to the United States of real property located within the boundaries of a national forest. The amount of the credit would be equal to the value of the property, or, if less, the amount of the estate tax liability.

We oppose enactment of these bills for several reasons. First, all estates are required by the Code to pay their taxes in cash or cash equivalents or a certain series of Treasury obligations, but do not authorize the Secretary of the Treasury to accept other forms of payment. We think that giving these estates the ability to pay their taxes in property would be unfair to other estates.

I might note that it is much more valuable than the charitable deduction that is given for other conveyances of property for the use of the United States.

Second, it is quite evident that the bills are a substitute for a direct appropriation of funds that would enable the U.S. Forest Service to acquire these lands. From the standpoint of debt management and budget policy, we believe that if the land is to be acquired, the money for its acquisition should be appropriated through the normal budget process and the costs should not be hidden through reduced tax collections. We think that would enable the Congress to focus more on the true nature of the proposed bills as appropriations measures rather than as tax measures.

Third, we are concerned that the precedential effect of these bills would lead to many additional requests for purchases of property through the use of estate tax credits or other kinds of tax credits. It would be very difficult to draw the line in this case.

We want to emphasize that our views are in no way addressed to the merits of the proposed acquisitions. We defer to the Agriculture Department on that subject. We comment only on the use of the private tax legislation to effect the acquisitions.

This concludes my prepared remarks. I would be happy to answer any further questions that you may have.

[The prepared statement of Mr. Woodward follows:]

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STATEMENT OF
ROBERT G. WOODWARD
ACTING TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
OF THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on the estate and gift tax matters before this Subcommittee today.

My statement will first discuss the policy issues raised by Senate Resolution 126, which expresses support for the estate and gift tax reductions enacted in the Economic Recovery Tax Act of 1981 (ERTA) that are scheduled to take effect after 1983, and S. 1250, which would repeal the estate and gift taxes. Next, I will discuss the generation-skipping transfer tax, including S. 1252 (which would repeal the generation-skipping transfer tax) and the Treasury Department's recent proposal to amend and improve that tax. Then, I will discuss in turn the various other bills before this hearing.

S. Res. 126 and S. 1250
Post-1983 Estate and Gift Tax Reductions Enacted in ERTA; Repeal of Estate and Gift Taxes

Background

The present estate tax was imposed by the Revenue Act of 1916, although the tax has undergone significant modifications since its original enactment. The present gift tax was enacted in the Revenue Act of 1932 to insure that comparable transfers of property would be subject to tax whether made by lifetime gift or at death. The rates and exemption levels under these taxes were at various levels from 1916 until the enactment of the Revenue Act of 1941 and the Revenue Act of 1942, which established the rates and exemption levels that remained in effect until the Tax Reform Act of 1976.

The Tax Reform Act of 1976 modified the estate and gift tax laws in numerous ways. It combined the estate and gift tax rate schedules into a single schedule based on each individual's cumulative transfers during lifetime and at death*/. The 1976 Act also repealed the separate $30,000 lifetime gift tax exemption and $60,000 estate tax exemption and replaced them with a "unified credit" against estate and gift taxes of $47,000. This unified credit was equivalent to an exemption for cumulative lifetime and at death transfers of $175,625. Finally, the 1976 Act imposed a tax on generation-skipping transfers to limit the avoidance of the estate and gift taxes through the use of generation-skipping trusts.

The Economic Recovery Tax Act of 1981 made many additional changes in the estate and gift tax laws, most of which were designed to reduce the burden imposed by those taxes. Among other things, ERTA enacted annual increases in the unified credit available in the years from 1982 through 1987. When fully effective in 1987, the increased unified credit will provide an exemption from gift and estate tax for cumulative lifetime and at death transfers of up to $600,000. In addition, ERTA reduced the top estate and gift tax rate from 70 percent to 50 percent, through annual reductions of 5 percentage points each year from 1982 to 1985.

1/ Under the provisions enacted in the Tax Reform Act of 1976, the transfer tax base includes amounts payable as estate taxes and amounts payable as gift taxes on gifts made within 3 years of death. The tax base does not include amounts payable as gift taxes on gifts made over 3 years before death.

Description of S. Res. 126 and S. 1250

Senate Resolution 126 expresses the sense of the Senate that the reductions in the Federal estate and gift taxes scheduled to take effect after 1983, as provided by ERTA, should not be modified. S. 1250 would repeal the Federal estate, gift and generation-skipping transfer taxes.

Discussion

This Administration has repeatedly expressed its concern over the disincentives to savings and capital formation caused by excessive estate and gift taxes. To reduce these undesirable economic effects, we strongly supported the lowering of the top estate and gift tax rates, the increase in the unified credit, the enactment of an unlimited marital deduction, and other estate and gift tax reforms made in ERTA. ERTA phased in the lowering of the top estate and gift tax rate and the increase in the unified credit over a number of years, primarily because of revenue constraints. Many taxpayers have taken the estate and gift tax reductions scheduled after 1983 into account in their current planning. More importantly, the reasons for enacting the estate and gift tax reductions in ERTA have not changed. Thus, the Administration fully supports Senate Resolution 126, which expresses the sense of the Senate that the estate and gift tax reductions enacted in ERTA should remain undisturbed.

S. 1250 raises the important question of whether the estate and gift tax changes enacted in ERTA went far enough. These changes merely reduced the disincentives to savings and investment and the tax-motivated distortions of economic behavior caused by the estate and gift taxes. Despite the changes made in ERTA, valid arguments can be made in support of repeal of the estate and gift taxes in their current form. Nevertheless, these taxes will raise nearly $6.1 billion in fiscal year 1983 and nearly $5.9 billion in fiscal year 1984. In view of current budget deficits, we think it is unrealistic to consider the elimination of this revenue. Thus, instead of repealing the estate and gift taxes, our short-term goal should be to make the current estate and gift tax system operate more fairly and rationally.

S. 1252 and the Treasury Proposal to Simplify and Improve the Generation-Skipping Transfer Tax

On November 4, 1981, the Treasury Department testified before this Subcommittee on S. 1695, a proposal in the 97th Congress that is identical to the current proposal in S. 1252 to repeal the generation-skipping transfer tax imposed by Chapter 13 of the Internal Revenue Code. At that time, we stated our opposition to the repeal of Chapter 13, but we went on to suggest a number of ways in which the generation-skipping transfer tax might be simplified and improved. We also stated that we were studying additional ways to simplify Chapter 13 without compromising its underlying purpose.

Our study culminated in the release on April 29, 1983, of a proposal for a new and fundamentally different generation-skipping transfer tax. This proposed new tax would be simpler than the present tax and would affect the estate planning of a much smaller class of taxpayers. At the same time, it would be fairer and more effective than present Chapter 13. A copy of our April 29 proposal is attached to this statement.

The proposal aims to achieve its objective by making three fundamental changes in the generation-skipping transfer (GST) tax system. First, every individual would be permitted to make transfers aggregating as much as $1,000,000, during lifetime and at death, which would be wholly exempt from the GST tax. Second, generation-skipping transfers not covered by the $1,000,000 exemption would be taxed at a flat rate equal to 80 percent of the highest estate tax rate in effect at the time of the transfer. This means that for taxable generation-skipping transfers after 1984, the tax rate would be 40 percent. Third, the proposal would tax direct generation-skipping transfers (to the extent that they are not covered by the new $1,000,000 exemption) as well as transfers through multi-generational trusts.

The details of our proposal are set forth in our release of April 29, 1983. I will not repeat them here, although I would be happy to answer any questions you might have regarding the proposal. I would like to use this opportunity primarily to discuss what I believe to be some of the fundamental issues relating to the tax treatment of generation-skipping transfers.

What Is A Generation-Skipping Transfer?

In order to determine whether a tax on generation-skipping transfers is necessary and, if so, what form such a tax should take, it is first necessary to decide what it is meant by the term "generation-skipping transfer." There are essentially two schools of thought on this issue. The first school of thought, which I will call the "generation-sharing" school, believes that a generation-skipping transfer is one which allows a beneficiary in a generation below the transferor to enjoy benefits of ownership in property without such property being included in his estate when it is ultimately transferred to (or for the benefit of) beneficiaries in an even lower generation. The classic example of this type of generation-skipping transfer is a transfer of property in trust, with a child of the transferor receiving the income for life and the remainder going to the transferor's grandchildren at the child's death. The existing generation-skipping transfer tax statute deals only with this type of generation-skipping transfer.

The second school of thought, to which the Treasury belongs and to which I will refer as the "broad-based" school, believes that a generation-skipping transfer is any transfer of property to or for the benefit of persons two or more generations below that of the transferor without the payment of estate or gift tax in the "skipped" generation, regardless of whether any person in the skipped generation had any ownership interest in the property. The broad-based definition includes "direct" generation-skipping transfers as well as transfers where a member of the skipped generation has an interest in or power over the property. Thus, a gift directly to the transferor's grandchildren, in trust or otherwise, is included in the broad-based definition of generation-skipping transfers.

The Need For A Broad-Based Approach

As starting points, the generation-sharing and broad-based analyses may be equally valid. However, the generation-sharing approach leads to three fundamental problems which can be resolved only by shifting to the broad-based approach:

- Neutrality. Taxing generation-skipping transfers in generation-sharing trusts while allowing direct transfers to the same ultimate recipients to pass free from additional tax discourages the use of generation-sharing trusts. This is socially undesirable since there are many legitimate, non-tax reasons for transferring property through generation-sharing trusts.

- Equity. A system which imposes an additional tax on generation-sharing trusts but does not tax direct generation-skipping transfers is biased in favor of the very wealthiest taxpayers since they are in the best position to make substantial transfers (relative to their total wealth) which skip their children's generation entirely.

- Simplicity. The generation-sharing approach requires a determination of whether a member of the skipped generation (typically a child of the transferor) has an interest in a trust sufficient to make it a "generation- skipping trust." The question of where to draw the line is a difficult one which inevitably leads to statutory and planning complexity. The broad-based approach avoids this complexity.

I would like to discuss each of these three considerations in greater detail.

Neutrality

The transfer tax system should strive to be a neutral consideration for a taxpayer in deciding how to transfer his accumulated wealth to his family members. Aside from the fact that a transfer tax system which is not neutral is inevitably unfair, a system which is not neutral also encourages taxpayers to dispose of their property in ways that they would not choose absent tax considerations. For example, were it not for the tax-saving potential of generation-skipping transfers, many more taxpayers would doubtless choose to leave most of their property outright to their children. The generation-sharing approach to the GST tax encourages taxpayers to make direct transfers to their grandchildren and great-grandchildren through "layering" techniques that can be a rather inflexible means of transferring property, rather than making transfers by means of flexible generation-sharing trusts.

Equity

One of the strongest arguments for enacting the GST tax in 1976 was that a transfer tax system with no GST tax discriminated against taxpayers of modest wealth. To assure their children's comfort and well-being, it was argued, taxpayers of modest wealth could not afford to give the children only an income interest (plus limited powers of withdrawal); the children needed the entire interest in the property to continue the standard of living of the older generation. Moreover, the substantial expenses of setting up and administering multi-generational, discretionary trusts could not be justified in the case of modest accumulations of wealth. A study conducted jointly by Treasury and the Brookings Institution relating to estate tax returns of decedents dying in 1957-1959 confirmed that generation skipping was primarily the domain of the wealthy.

It is highly ironic that the GST tax enacted in 1976, which attempted to redress an inequity between taxpayers of modest wealth and wealthy taxpayers, may have instituted an equally serious inequity between "wealthy" taxpayers and "extremely wealthy" taxpayers. While all wealthy taxpayers may be able to afford to set up generation-skipping trusts which avoid an estate tax in the children's generation, only the extremely wealthy can afford to engage in "layering," which avoids both the estate tax and the GST tax in the children's generation.

The American Bar Association, in its response of May 21, 1982 to Treasury's 1981 testimony on generation-skipping transfers, presented this equity consideration as a reason for repealing the GST tax. While Treasury agrees with the equity concern, we believe that it is a strong argument for extending the GST tax to direct transfers rather than for repeal.

Simplicity

Current Chapter 13 amply demonstrates the pitfalls of trying to draw a line between those multi-generational trusts which are subject to the GST tax and those which are not. Initially the statute starts from the premise that a power over trust income or corpus is as much an incident of ownership as a right to receive such income or corpus. An exception is provided, however, for what is probably the most important power a member of the skipped generation would want, i.e., a power to appoint trust property among lineal descendants of the grantor (typically children, grandchildren, nieces and nephews of the person holding the power). Special rules are also necessary for powers held by trustees. On the other hand, no attempt is made to exclude any present interest in trust property, no matter how contingent nor inconsequential.

The broad definition of generation-skipping transfers, which includes direct transfers, avoids this line-drawing process entirely. Hence it would be much simpler to deal with in drafting a statute and in estate planning. In determining whether a transfer is a generation-skipping transfer, the only question that needs to be answered is whether a transfer has been made to a person two or more generations below the transferor without payment of a transfer tax in an intervening generation.

Relationship Between Tax Rate and Exemption Amount

Treasury has proposed that each transferor be given a $1,000,000 GST tax exemption and that a flat rate equal to 80 percent of the top estate tax rate (i.e., 40 percent for transfers after 1984) apply to generation-skipping transfers in excess of the exemption. The $1,000,000 exemption amount was chosen for essentially two reasons. First, it is high enough to exclude the majority of estates from the GST tax system. This facilitates estate planning for the excluded individuals and also eases administration of the system. On the other hand, the amount is low enough to include within the system most people whose estate plans involve generation skipping. These people and their children are not invariably in the top transfer tax bracket. However, since they are generally in relatively high brackets, applying a rate equal to 80 percent of the top estate tax rate to transfers by such individuals seems reasonable.

In general, the combination of the proposed exemption amount and rate will assure that the GST tax payable on any given transfer will be comparable to, but generally will not exceed, the estate or gift tax which is avoided by the transfer. The proposed rules for determining when the GST tax base includes the amount of GST tax (like the present estate tax) or excludes the GST tax (like the present gift tax) are also designed to achieve this result. In general, the proposed GST tax is premised on the notion that a direct generation-skipping transfer results in the avoidance of a gift tax in the skipped generation, so the GST tax base does not include the amount of GST tax in this case. A generation-skipping transfer through a multi-generational trust usually results in the avoidance of an estate tax in the skipped generation, so the proposed GST tax base in this case would include the amount of tax.

We concede that the use of a flat rate for the generation-skipping transfer tax which is lower than the top estate tax rate may allow transferors in the highest brackets to pay a lower GST tax than the transfer tax avoided in the skipped generation. We do not believe, however, that this is a major cause for concern. The proposed GST tax would substantially reduce the tax advantages of generation-skipping transfers, even if it would not eliminate them entirely. Moreover, as present Chapter 13 demonstrates, a system which attempts to match exactly the GST tax with the estate or gift tax which is avoided can be extremely complex and difficult to administer.

Transferability of the $1,000,000 Exemption Between Spouses

Under the Treasury proposal, each individual would be entitled to a $1,000,000 GST tax exemption. It is anticipated that the gift tax return would be modified to provide for an allocation of the GST tax exemption to gifts made during the calendar period covered by the return or in any prior calendar period. Any portion of the exemption not used during the individual's lifetime could be allocated by his executor to transfers made by that individual, whether during lifetime or at death.

In light of the unlimited gift tax marital deduction, the proposal would allow the exemption to be allocated to transfers made by the spouse of the individual having the exemption, as well as to transfers by that individual. Indeed, we would be willing to modify our proposal to allow an individual to transfer any unused GST tax exemption at his death to his surviving spouse. This would allow a married couple the option of waiting until the death of the surviving spouse to decide how to allocate their combined $2,000,000 GST tax exemption.

In general, it is Treasury's goal to assure that a married couple with a combined estate of $2,000,000 or less will be virtually free from GST tax concerns in formulating their combined estate plan. We would be happy to work with all interested parties to formulate the approach which best assures that this would be the case.

The Significance of Tax-Avoidance Motive

Members of the generation-sharing school of thought contend that direct transfers should not be subject to a generation-skipping transfer tax because direct transfers are generally not motivated by tax avoidance. In Treasury's view, a tax-avoidance motive is irrelevant; the test should be whether a transfer has a tax-avoidance effect. A generation-skipping transfer, whether direct or through a generation-sharing trust, means that the property transferred will remain outside the transfer tax system for two or more generations. Families which transfer their cumulative wealth in this fashion are thus paying a lower aggregate transfer tax than families which transfer property directly from generation to generation. There is no reason why a rational tax system should discriminate in this manner.

Our broad-based approach also rejects the notion that it is possible to formulate a fair, objective test of whether a transfer is motivated by tax avoidance. Present Chapter 13, for example, undoubtedly applies to many trusts which were created with no tax avoidance motive whatsoever. On the other hand, direct transfers are not invariably free from tax avoidance motive, especially those in excess of $1,000,000.

The Case of the Predeceased Child

We have received some comments, and undoubtedly you will hear testimony today, about the hardship of imposing a generation-skipping transfer tax on a direct transfer from a grandparent to his grandchild after one or both of the grandchild's parents have died. While we concede that any additional tax on a transfer to an orphan may appear harsh, we do not believe that it is necessary to provide any special rule to cover this situation for several reasons. First, while the fact that the grandchild's parents are deceased may prove that the transfer was not motivated by tax avoidance, the transfer has the same tax effect as if the child's parents were alive at the time of the transfer. As stated above, we believe that motive is irrelevant and effect is crucial. Second, the $1,000,000 exemption given each transferor, which may be allocated entirely to transfers to the orphaned grandchildren, would provide adequate protection to grandchildren of transferors of modest wealth. Just as the estate tax "orphan's deduction" was repealed in 1981 in conjunction with the expansion of the broad-based protection afforded by the unified credit, the $1,000,000 exemption eliminates the need for any special treatment for transferees whose parents are deceased.

The only valid argument of which we are aware in favor of a special rule for transfers to a grandchild whose parents have died is that the transferor may have lost the opportunity to make transfers through the deceased child which would be exempt from tax in the child's generation by the child's unused unified credit. In general, we question whether it is likely that many couples with combined estates of over $2,000,000 will have an adult child who predeceased them leaving one or more children and an estate insufficient to use up his unified credit. We would be willing to consider, however, a limited amendment to our proposal to take care of any such situations. Again, we note that the complexity of such an amendment might outweigh any perceived gain in equity.

Transfers Which Skip More Than One Generation

Treasury's proposed GST tax would apply only once to any given generation-skipping transfer, regardless of the number of generations skipped. While we concede that this deviates somewhat from the broad-based view of generation-skipping transfers, we believe that the decision to limit the GST tax to a single application reflects a reasonable balance of competing considerations. A double application of the GST tax, when coupled with an estate or gift tax, produces a result that could be viewed as harsh. Moreover, a GST tax which applied to a given generation-skipping transfer at every generation level would involve a significant degree of additional statutory and computational complexity. Finally, from a revenue standpoint, the additional tax collected from a second application of a generation-skipping transfer tax would be relatively insignificant.

On the other hand, limiting the GST tax to a single application may allow some transfer tax avoidance in lower generations through long-term trusts. This is especially true in states such as Wisconsin where the duration of such trusts is not limited by the rule against perpetuities. If these trusts are felt to be a significant problem, we would be happy to attempt to devise a solution which does not unduly complicate the proposed tax.

Need for Prompt Action

Since the beginning of 1983, the present generation-skipping transfer tax has been fully in effect. Thus, many individuals with pre-June 11, 1976 wills and revocable trusts are now faced with the question of whether these wills and trusts should be amended to take into account present Chapter 13. The legislative uncertainty has made estate planning in this area difficult. We believe that a clear statement of what the law will be is needed as soon as possible.

Undoubtedly, many of those testifying today will urge repeal of present Chapter 13 pending further study of the generation-skipping problem. While Treasury is aware that the American Law Institute and other groups are currently studying this issue, we strongly urge the Congress not to support an outright repeal of present Chapter 13 without a new GST tax in its place. Instead, Treasury would urge that a statute based on our proposal be enacted as soon as possible, effective immediately for transfers during the transferor's lifetime but with the effective date postponed for one year for generation-skipping transfers occurring at or after the transferor's death. In this way, no one will be subject to the new tax during its first year after enactment unless he chooses to make a lifetime gift. Also, during this one-year transition period, there would be ample opportunity for the affected individuals and their advisors to study the new law and adjust their planning as needed.

S. 1210
Election of Alternate Valuation Date on Late Estate Tax Returns

Background

Current law provides generally that property included in a decedent's gross estate is valued for estate tax purposes on the date of the decedent's death. However, Internal Revenue Code section 2032 provides that, if the executor elects, the property shall be valued on the date six months after the date of the decedent's death (the "alternate valuation date"). The election to use the alternate valuation date was intended to lessen the impact of the estate tax when property held by a decedent declines in value shortly after the decedent's death. Under current law, the alternate valuation date election is available only if the election is made on a timely filed estate tax return (taking into account extensions of time for filing).

Description of S. 1210

S. 1210 provides that the election to use the alternate valuation date shall be available only if (1) the first estate tax return filed by the estate shows that some estate tax is in fact owing and (2) the executor certifies that the value of the gross estate (excluding property for which a marital or charitable deduction is allowed) at the alternate valuation date is less than the value of the gross estate (again, excluding property for which a marital or charitable deduction is allowed) at the date of death. The bill would permit, however, an election to use the alternate valuation date even if the estate tax return is filed late, provided that the return is filed no later than one year after the time prescribed for filing (including extensions). Moreover, no election would be permitted on a late return if one of the principal purposes for filing the return late was to make the election.

In general, these new provisions would apply to estates of decedents dying after the date of enactment. A transitional rule would allow the alternate valuation date election for certain other estates which did not file a timely estate tax return but which meet the tests imposed by the bill for elections on late filed returns. An election under this transitional rule must be made within one year of the date of enactment, and the estate tax return of the estate must be open under the statute of limitations.

Discussion

The Treasury Department generally supports the basic principles incorporated in S. 1210. However, we object to certain provisions of the bill as currently drafted.

Although the alternate valuation date election is intended to provide estate tax relief to estates whose assets decline in value in the six months after the decedent's death, it can be used under current law as a means of reducing the income taxes of beneficiaries of estates whose assets have increased in value during that six-month period. This opportunity exists because the heirs' "stepped up" basis in inherited property is generally fixed by the estate tax valuation.

Because of the increase in the unified credit and the unlimited marital deduction enacted in ERTA, there are many estates that may use the alternate valuation date to increase the income tax basis of property in the estate where the decedent's property has appreciated in the six months after the date of death. This technique is possible because the increased unified credit and the unlimited marital deduction will prevent any significant estate tax cost attributable to the higher estate tax valuation. Alternate valuation thus may permit heirs to receive the benefit of six months worth of appreciation in value of inherited property free of estate and income taxes. In these cases, a provision intended to benefit estates whose assets decline in value provides an unintended windfall for heirs who receive property that appreciates rapidly after the decedent's death.

S. 1210 represents an effort to confine section 2032 to its original purpose by limiting the availability of the alternate valuation date election to those estates which initially owe an estate tax, and by tying use of the alternate valuation date to cases in which there is a decline in value of at least some estate property. S. 1210 thus attempts to ensure that the election will not be used to provide an income tax windfall to the heirs at no estate tax cost. We strongly support this general reform of section 2032. However, we believe that S. 1210 does not go far enough in this regard. The bill would still allow use of the alternate valuation date as a means of providing benefits to those inheriting property for which a marital deduction was claimed by the estate. Thus, S. 1210 limits but does not prohibit use of the alternate valuation date as a means of income tax avoidance.

For instance, under the bill as drafted, the alternate valuation date could still be used primarily to reduce the income tax liability of surviving spouses when there is a relatively small estate tax benefit to the estate. Let us assume that an individual dies in 1983 leaving a gross estate valued at the date of death at $10 million, $9 million of which is transferred to the surviving spouse. The taxable estate is $1 million which produces a tentative estate tax of $345,800, against which a unified credit of $79,300 is allowed, leaving a net estate tax of $266,500. Assume that the value of the assets not transferred to the spouse decline by $5,000, while the assets transferred to the spouse increase in value by $1 million. The alternate valuation date election would be available under the bill, even though the gross estate has increased in value by $995,000. Estate tax savings from the use of the alternate valuation date would be $1,950. However, the potential income tax benefit to the surviving spouse would be $200,000, assuming that the surviving spouse is in the 50% marginal income tax bracket and that gain on the sale of the appreciated property would be long-term capital gain. This result occurs because the surviving spouse's basis in the inherited property for income tax purposes would be determined as of the alternate valuation date.

Thus, although S. 1210 moves in the right direction, it would be far preferable if the bill required that the entire gross estate, and not just the non-marital and non-charitable property, must decline in value before alternate valuation can be elected. In many large and well planned estates, spouses and charities will be the major beneficiaries. These estates are most likely to exploit the undue income tax benefit that still would be allowed by S. 1210 in its current form. Another alternative approach to the problem addressed by S. 1210 might be to provide simply that where an estate elects to use the alternate valuation date, the income tax basis of each asset in the estate will be the lower of its fair market value on the date of death or the alternate valuation date.

The transitional rule of S. 1210 also would permit certain late filing estates to make retroactive elections to use the alternate valuation date within a year of the bill's enactment. We oppose this provision of the bill. It could provide a windfall to estates whose late filed returns are by chance open at the date of enactment, while denying relief to other estates whose returns are closed as of the date of enactment. Retroactive application of the change made by the bill also may create administrative problems by requiring redeterminations of the income tax basis of property included in the estates that make retroactive elections.

To summarize, although we have concerns with respect to certain aspects of the bill, we believe S. 1210 is a step in the right direction. We would be delighted to work with this Subcommittee in drafting legislation that would permit alternate valuation date elections on late filed returns in certain cases but would incorporate the safeguards we have suggested.

S. 1180

Gift Tax Relief for Certain Disclaimers

Background

Section 25.2511-1(c) of the Gift Tax Regulations, which was published on November 15, 1958, provides that a refusal to accept ownership of property transferred to an individual constitutes a taxable gift by the individual to the person who takes the property as a result of the refusal, unless the refusal is made "within a reasonable time after knowledge of the existence of the transfer." (Because of the enactment of Internal Revenue Code section 2518 in the Tax Reform Act of 1976, this regulation relates only to interests created in taxable transfers made before 1977.) In the case of property transferred in trust, the position of the Internal Revenue Service generally is that the transfer of property to the trust is the "transfer" that begins the "reasonable time" period prescribed by the regulation. Thus, under the regulation, a trust beneficiary may make a tax-free disclaimer of his interest in the trust only if the disclaimer is made within a reasonable period of time after the beneficiary learns of the creation of his interest in the trust.

In the case of *Jewett v. Commissioner*, 545 U.S. 305 (1982), the taxpayer argued that the reasonable time period for a trust beneficiary's disclaimer should begin only after the beneficiary's interest in the trust becomes vested. The Supreme Court, however, rejected the taxpayer's argument, concluding that the IRS position as to the commencement of the reasonable time period was supported by both the text and administrative history of the 1958 regulation. The Court also summarily rejected the taxpayer's argument that it was unfair to apply the 1958 regulation "retroactively" to an interest that had been created previously, finding that the taxpayer had no "right" that was "taken away" by the regulation. In rejecting the taxpayer's equitable arguments, the Court observed pointedly that the taxpayer made no argument that the taxation of disclaimers under the 1958 regulation is inconsistent with the statutory provisions imposing a gift tax, which were enacted long before the creation of the trust in question.

The Supreme Court's decision in Jewett had the effect of resolving a number of pending gift and estate tax cases involving the interpretation of the 1958 regulation against the taxpayers and in favor of the government. These taxpayers are now seeking legislative relief in S. 1180.

Description of S. 1180

S. 1180 would provide that any interest created by a transfer prior to November 15, 1958, can be disclaimed without estate or gift tax consequences to the person makingthe disclaimer if the disclaimer is made not later than 90 days after the date of the bill's enactment. Thus, the bill would relieve the existing gift tax liabilities of the taxpayers in the pending cases controlled by the Jewett decision. The bill also would provide a 90-day grace period to allow other beneficiaries of trusts created before November 15, 1958, to make tax-free disclaimers of trust property that might otherwise pass to them.

The basic premise of S. 1180 is that the 1958 Treasury regulation unfairly deprived beneficiaries of preexisting trusts of their right to make disclaimers of contingent interests. The arguments in support of this proposal are essentially the same as the equitable arguments made by the taxpayer in the Jewett case.

Discussion

The Treasury Department strongly opposes S. 1180. As the taxpayer acknowledged in Jewett, the 1958 regulation is clearly a correct application of the gift tax statute to the disclaimers in question. The equitable arguments advanced by the proponents of the bill concerning the "retroactive" effect of the regulation were fully considered and rejected by the Supreme Court in Jewett. We believe that the Supreme Court's judgment was correct and should not be overridden by the Congress.

In essence, S. 1180 seeks retroactive private relief for a group of taxpayers who knowingly and willingly took positions contrary to the Internal Revenue Service's interpretation of the gift tax statute. These taxpayers simply lost a calculated gamble and Congress should not now come to their rescue by enacting retroactive private relief legislation.

Moreover, the bill would open the way to significant transfer tax avoidance by individuals who stand to receive distributions under trusts established before November 15, 1958. Such individuals would be given clearance by the bill to make tax-free transfers (the amounts of which could be very substantial) by means of disclaimers filed within 90 days of the date of enactment of the proposal. This would be an unwarranted windfall for these individuals.

For the foregoing reasons, the Treasury Department strongly opposes S. 1180.

S. 953
Current Use Valuation Elections on Amended Estate Tax Returns

Background

Section 2032A(d)(1) of the Code, as amended by ERTA, provides that for estates of decedents dying after December 31, 1981, an election to use the current use valuation method provided by section 2032A must be made on the first estate tax return filed by the executor. For estates of decedents dying on or before December 31, 1981, the current use valuation election must be made by the time the estate tax return is due, taking into account any extensions of the filing date.

Description of S. 953

S. 953 would permit estates to elect to use the current use valuation method on an amended estate tax return. Moreover, the change would be made retroactive to the estates of all decedents dying after December 31, 1976.

Discussion

Treasury strongly opposes S. 953. Current use valuation is a departure from the normal method of valuing estate assets, intended to benefit heirs who wish to continue to use certain qualified real property in the manner in which it has been used by the decedent even if a higher and better use might be made of the property. The availability of current use valuation under section 2032A will depend on facts and circumstances that will be fully known to the executor of the estate at the time the initial estate tax return is filed. We can see no compelling reason why the time for making the election should be further deferred until the time for filing any amended return has passed.

The bill also would encourage noncompliance with the estate tax law. It would invite estates to value qualified real property on the first estate tax return at an amount substantially below fair market value without making an election under section 2032A. By so doing, the estate would attempt to avoid the provisions of section 2032A that require a recapture of the estate tax savings attributable to current use valuation in certain cases if the qualified real property is disposed of or ceases to be used for qualified purposes. If this bill were enacted, executors would be assured that there was no downside risk in following this procedure, since they could elect section 2032A valuation on an amended return if the original valuation were challenged by IRS.

Finally, we oppose the retroactive effective date of the bill. When Congress amended section 2032A in ERTA to allow the current use valuation election on late filed returns, it consciously decided to make the change applicable on a prospective basis. We see no reason for the Congress to reverse the judgment it made in ERTA in this regard.

S. 1251
"Section 6166 Technical Revision Act of 1983"

This bill is in all substantial respects identical to S. 2479, introduced in the last Congress. It makes sweeping revisions to section 6166 of the Internal Revenue Code, which provides for deferred payment of the estate tax when certain closely held business interests form a substantial portion of the estate.

On April 15, 1983, the Treasury Department submitted to this Subcommittee a detailed statement of our views on S. 2479. In general, Treasury strongly opposed enactment of that bill. The Treasury Department position on the bill remains unchanged since the April 15 statement. A copy of our April 15 statement is attached for your reference.

S. 309 and S. 310
Special Estate Tax Credits for the Estate of Nell J. Redfield and the Estate of Elizabeth Schultz Rabe

S. 309 would allow a credit against estate tax imposed on the estate of Nell J. Redfield for the conveyance by the estate to the United States of real property located within the boundaries of the Toiyabe National Forest. The amount of the credit would be the lesser of (1) the fair market value of the real property transferred by the estate as of the valuation date used for purposes of the estate tax, or (2) the Federal estate tax liability (and interest thereon) of the estate. The credit would apply only if the real property transferred is accepted by the Secretary of Agriculture and added to the Toiyabe National Forest. S. 310 is a similar bill that would grant an estate tax credit to the estate of Elizabeth Schultz Rabe in exchange for certain real property held by that estate.

The Treasury Department strongly opposes the enactment of these bills for several reasons.

First, the Internal Revenue Code authorizes the Secretary of the Treasury to receive cash, cash equivalents, and certain series of Treasury obligations in payment of estate tax liabilities, but does not authorize the Secretary to accept other forms of payment, such as the conveyance of real estate. By allowing the Redfield and Rabe estates to discharge their estate tax liabilities by transferring land to the United States, the bills under consideration would extend a benefit presently unavailable to other estates. Further, the tax credits granted to these estates would be much more valuable than the tax deductions given to other estates for contributions to property to the Federal government. Providing such special tax benefits to these particular estates would be unfair to all other estates, since other estates must discharge their estate tax liabilities with cash payments.

Second, it is quite evident that the bills are a substitute for a direct appropriation of funds that would enable the U.S. Forest Service to acquire the property in question. From the standpoint of debt management and budget policy, we believe that if the land is to be acquired, the money for its acquisition should be appropriated through the normal budget process, and the cost should not be hidden through reduced tax collections. This would enable Congress to focus more on the true nature of the proposed bills as appropriations measures, and to weigh the desirability of acquiring these lands against the merits of other possible uses of the funds.

Third, we are concerned about the precedential effect these bills would have for purchasing property for other worthy projects. It would be difficult to draw a line between projects for which this approach should be permitted and those for which it should be denied. The line-drawing would require the evaluation of the relative merits of the different worthy projects -- an evaluation for which the process of tax legislation is ill suited.

We wish to emphasize that our views are in no way addressed to the merits of the proposed acquisitions. We defer to the Department of Agriculture on the desirability of acquiring the land in question. Our objection is directed solely at the use of private tax legislation to effect the acquisitions.

A PROPOSAL TO SIMPLIFY AND IMPROVE THE GENERATION-SKIPPING TRANSFER TAX

Department of the Treasury
April 29, 1983

Background

In general, individuals possessing accumulated wealth wish to see that wealth retained by their families after they die. For a married couple, the most natural way to further this goal is for them to leave their combined assets to their children, since children are usually the closest and most mature family members. If each member of a family passes down accumulated wealth in this fashion, a Federal transfer tax will be paid on the family's wealth once per generation.

An individual can significantly decrease his family's overall estate tax burden, however, by transferring property in a way which "skips" one or more generations, i.e., by giving an interest in his assets to his grandchildren (or great-grandchildren) rather than directly to his children. This means of avoiding transfer taxes is greatly aided by the trust device, which enables a transferor to give the members of the skipped generation significant interests in and powers over the property transferred without causing the property to be subject to estate or gift tax in that generation. Generally, the only legal limitation on the number of generations for which the transfer tax can be skipped by transferring property in trust is the local law version (if any) of the Rule Against Perpetuities.

For at least two reasons, wealthier families are in a far better position to engage in generation skipping than those with more modest accumulations of wealth. First, generation-skipping arrangements generally entail substantial legal and administrative costs. These costs are much easier to justify as the size of the estate increases. Second, in terms of providing for their families, wealthier transferors are in a far better position to transfer a substantial portion of their wealth to grandchildren (or even lower generations) with only limited interests in their children. The wealthiest transferors, whose children generally have substantial wealth of their own, can make substantial transfers which totally skip their children's generation without risking any financial hardship to the children.

The unfairness of a system which subjects families of modest wealth to estate tax every generation and which allows wealthier families to avoid the tax for one or more generations was recognized as early as the 1940s. By the 1960s, there was widespread agreement that generation skipping was a problem, but there was no consensus on what to do about it. The Treasury and organizations such as the American Law Institute, American Bankers Association, and American Institute of Certified Public Accountants separately studied the issue and proposed solutions which varied as much in their general philosophies as in their specific details. In 1973, a panel discussion was held before the House Ways and Means Committee where a number of the most knowledgeable and most highly respected estate planning experts in the country testified. Again, there was general agreement both that generation skipping was a problem that needed attention and that any effective solution would not be a simple one.

Present Law

The result of these studies and debates was the passage in 1976 of the Tax on Certain Generation-Skipping Transfers -- Chapter 13 of the Internal Revenue Code. This tax, designed to be separate from but complementary to the estate and gift taxes, is based on three fundamental principles:

(1) The tax applies only to "generation-skipping trusts" and "trust equivalents." A generation-skipping trust is one which provides for a splitting of benefits between two or more generations of "beneficiaries" who belong to generations which are younger than the generation of the grantor of the trust ("younger generation beneficiaries");

(2) The tax is imposed only if and when a "generation-skipping transfer" actually occurs; and

(3) The tax is to be substantially equivalent to the tax which would have been imposed if the property had actually been transferred outright to each successive generation. This is achieved by choosing an appropriate member of the skipped generation (the "deemed transferor") whose estate or gift tax rate is used as a measuring rod for purposes of determining the tax imposed on the generation-skipping transfer.

Generally, a person is considered a "beneficiary" of a trust if he has either a present or future "interest" or "power" in the trust. Certain exceptions apply, however. A mere right of management over trust assets or a power to appoint trust assets among the lineal descendants of the grantor is not treated as a power for purposes of Chapter 13. On the other hand, even a contingent possibility of receiving trust income or corpus is treated as an "interest," no matter how remote the contingency.

A generation-skipping transfer means any "taxable distribution" or "taxable termination" with respect to a generation-skipping trust or trust equivalent. The term "taxable distribution" means any distribution (excluding certain distributions of trust accounting income) from a generation-skipping trust to any younger generation beneficiary at least two generations below the grantor, but only if another person is a younger generation beneficiary of the trust in a higher generation. Distributions of trust accounting income generally are not treated as taxable distributions. However, when there are distributions of both income and corpus within the same taxable year of the trust, a special source rule limits the application of the income exception by attributing the income distribution first to the older generation beneficiaries. A "taxable termination" is defined as the termination of an interest or power of a beneficiary in a generation lower than the grantor if the trust has some other beneficiary assigned to an even lower generation. A number of exceptions and postponement rules are included to deal with (i) beneficiaries with multiple interests and powers and (ii) trusts with more than one beneficiary in the same generation. Also, the terms "taxable distribution" and "taxable termination" do not include any transfer that vests the property in a grandchild of the grantor, up to a limit of $250,000 per deemed transferor.

Once it has been determined that there has been a taxable termination or taxable distribution, the amount of tax due (if any) must be computed. The first step is to determine the identity of the "deemed transferor." This is generally the parent (whether or not living at the time of the transfer) of the beneficiary benefiting from the taxable distribution or termination who is more closely related to the grantor of the trust. If, however, such parent is not a beneficiary of the trust, but there is another ancestor of the beneficiary who is also a younger generation beneficiary and who is related by blood to the grantor, the youngest of such ancestors is the deemed transferor.

The next step is to compute the tax at the marginal transfer tax rate of the deemed transferor. If the transfer occurs at the same time as or after the death of the deemed transferor, any unused portion of the deemed transferor's unified transfer tax credit is allowed as a credit against the Chapter 13 tax. A number of other credits, deductions, and special rules also apply. Primary liability for payment of the tax is imposed on the distributee in the case of a taxable distribution and on the trustee in the case of a taxable termination. The statute and the legislative history anticipate that trustees will obtain information needed to make the computation of the Chapter 13 tax from the Internal Revenue Service and that the tax liability will be limited to the tax computed on the basis of the information so obtained.

Chapter 13 generally applies to transfers made after June 11, 1976. The tax does not apply, however, in the case of transfers under irrevocable trusts in existence on June 11, 1976, except for transfers attributable to corpus added to such trusts after that date. Additionally, in the case of any decedent dying before January 1, 1983, the tax does not apply to transfers pursuant to the decedent's will (or a revocable trust which becomes irrevocable by reason of the decedent's death) if the will (or revocable trust) was in existence on June 11, 1976, and was not amended (except in respects which do not result in the creation of, or increase the amount of, a generation-skipping transfer) at any time after that date.

Reasons for Change

Primarily because of the liberal transition rules, taxpayers and the Government have had virtually no experience with the actual imposition of tax under Chapter 13. However, Chapter 13 has been the subject of intense scrutiny by estate tax scholars, by individual estate planning practitioners, and by groups such as the American Bar Association, the American Bankers Association, and numerous regional bar associations. In contrast to the general consensus prior to 1976 that a generation-skipping transfer tax was an essential feature of an equitable transfer tax system, present Chapter 13 has been the subject of widespread criticism. As a result, numerous bills have been introduced in Congress in the past several years calling for its repeal.

There are a number of real problems with the present generation-skipping transfer tax. The principal problems with the present Chapter 13 may be summarized as follows:

- Scope - Every trust, no matter how small, which has beneficiaries in two or more generations below the grantor is a generation-skipping trust subject to the provisions of Chapter 13. Yet such trusts are found in even the simplest of wills, often drafted by general practitioners whose knowledge of the intricacies of

Chapter 13 is necessarily limited. Trustees of many of these smaller trusts are also unsophisticated in Federal tax matters. The broad scope of Chapter 13, coupled with its extraordinary complexity and the lack of sophistication of many of the lawyers advising those who are subject to the tax, is likely to result in a high level of inadvertent noncompliance and an uneven application of the tax.

- Complexity - As noted above, Chapter 13 is extremely complex. It has no fewer than thirteen defined terms which fit into an intricate pattern of rules and exceptions. The tax is difficult to understand, even for tax practitioners who specialize in estate planning, and can be a major complicating factor in advising clients. The cost of this complexity is borne in part by taxpayers, through increased fees for estate planning; in part by the Government, to the extent these fees are taken as income tax deductions; and in part by practitioners, to the extent the extra time spent mastering Chapter 13 cannot be billed to clients.

- Administrability - Chapter 13 is also unduly complex from an administrative standpoint. Every person alive on or after June 11, 1976 is potentially a deemed transferor. Thus, the Internal Revenue Service theoretically must stand ready to provide estate and gift tax information regarding every one of these individuals (including any unused portion of their unified credits), regardless of whether they or their estates have ever filed a Federal gift or estate tax return. Given the fact that the estate of a decedent dying after 1986 will not be required to file an estate tax return unless the decedent's gross estate and cumulative taxable gifts exceed $600,000, it is likely that the Service will be unable to determine the amount of the unused unified credit of the deemed transferor in a large number of cases. Even assuming the necessary data concerning the unused unified credit and other matters could be obtained, the information storage and retrieval system required would be extremely costly to maintain and operate.

- Effectiveness - Because of the numerous exceptions, generation-skipping arrangements can easily avoid Chapter 13 in many cases. The wealthiest transferors can avoid the tax at the generation level of their children (and grandchildren) by "layering" their estates, that is, by passing large portions of their wealth to their grandchildren (and great-grandchildren) through trusts in which no member of an intervening generation has a taxable interest or power. Also, the $250,000 exclusion for transfers to grandchildren, the "lineal descendants" exception to the "power" rule, and the income exception to the definition of taxable distribution give well-advised taxpayers many opportunities to avoid the tax. In sum, present Chapter 13 probably will not eliminate most generation-skipping arrangements. In many cases, it will simply encourage taxpayers to adopt more complex estate plans which deviate further from their natural dispositive preferences.

- Fairness - The complexity and ineffectiveness of present Chapter 13 are also sources of unfairness. Both factors discriminate in favor of the "super wealthy" as compared to families of more modest wealth. The wealthiest families are in a much better position than families of more modest wealth to incur the cost of the highly sophisticated tax advice and administrative fees necessary to understand and exploit the complexities of the present statute. Moreover, the children of the wealthiest individuals usually are wealthier than the children of individuals of more modest wealth. This means that the wealthiest individuals can afford to leave a larger portion of their estates in a manner which skips their children's generation entirely. For example, a married couple with a combined estate of $30,000,000 may well leave only a small fraction of their property to each child (or in a conventional generation-skipping trust) while the bulk of their combined estate is divided among trusts for their grandchildren and great-grandchildren. The children's well-being is probably not a major concern since they usually will have substantial wealth of their own, perhaps acquired in part through pre-1976 gifts and generation-skipping transfers from higher generations. On the other hand, a couple with a combined estate of $3,000,000 would often be unwilling (and perhaps ill-advised) to leave any substantial portion of their wealth in a form which deprives their children of any interest in the property. There is no good reason for the Federal tax system to encourage testators to pass over their children in favor of their grandchildren and great-grandchildren, as present Chapter 13 now does.

- Lack of Logical Consistency - Chapter 13 is not based on any logically consistent view of the Federal transfer tax system. Because of its failure to tax direct generation-skipping transfers and its numerous special rules and exceptions, Chapter 13 does not assure that a transfer tax is imposed at least once per generation. On the other hand, because it can apply to virtually any trust or trust equivalent that might benefit individuals in more than one generation, the tax is not limited to extreme cases of transfer tax avoidance.

In spite of these problems with the present system, the need for some sort of tax on generation-skipping transfers remains strong. The validity of the concerns about generation-skipping which have been voiced repeatedly over the course of more than four decades has not been diminished by the difficulties which have been encountered with the 1976 statute. In light of this, the proposal which follows is presented as the basis for a workable approach to the generation-skipping problem and a meaningful alternative to outright repeal of Chapter 13.

Simplification Proposal

General Explanation

The overriding objective of this proposal is to replace the present generation-skipping transfer tax with one which is considerably simpler than the present tax and which has potential application to a much smaller number of individuals, but which also is fairer and more effective than present Chapter 13. While some of the mechanical rules in the present statute would be retained with little or no modification, the proposal is not simply an attempt to "patch up" some of the problem areas in the existing Chapter 13. It represents a fundamentally different and far simpler approach to the problem of generation skipping.

The proposal aims to achieve its objective by making three fundamental changes in the generation-skipping transfer tax system.

Exemption of $1,000,000 Per Grantor

First, every individual will be permitted to make transfers aggregating as much as $1,000,000, during lifetime and at death, which will be wholly exempt from the generation-skipping transfer (GST) tax. Lifetime transfers that qualify for gift tax exclusion also would be excluded for GST tax purposes. The exclusion in present Chapter 13 for transfers to the grantor's grandchildren of $250,000 per deemed transferor would be eliminated.

Under the new $1,000,000 per transferor exemption, a married couple with a combined estate of $2,000,000 or less can easily plan their estate so that their property will not be subject to the generation-skipping transfer tax at all. This change also will restrict the GST tax to the domain of the wealthiest families, where generation skipping is most prevalent and results in the largest revenue losses.

Flat Rate Tax on Non-Exempt Transfers

Second, generation-skipping transfers not covered by the $1,000,000 exemption would be taxed at a flat rate equal to 80 percent of the highest estate tax rate in effect at the time of the transfer. This means that for taxable generation-skipping transfers after 1984, the tax rate will be 40 percent.

A flat rate will greatly simplify the administration of the GST tax system. No information regarding deemed transferors will need to be stored and retrieved, and computation of the tax will be relatively straightforward.

The shift to a flat rate tax will not be unfair to taxpayers with moderate-sized estates. The combination of the $1,000,000 exemption and the 40 percent rate will assure that the GST tax payable on a generation-skipping transfer will almost always be less than the estate or gift tax which would have been payable had the property been passed through the skipped generation. Also, the benefits of the $1,000,000 exemption will generally outweigh any benefits available under the present system from the $250,000 exclusion for transfers to grandchildren.

The 40 percent rate may provide some tax savings to the wealthiest families, since they will be able to use generation-skipping transfers to transfer property to lower generations at tax rates below the highest estate tax rate. However, a GST tax with a flat rate equal to 80 percent of the top estate tax rate leaves much less incentive for the wealthiest taxpayers to use generation-skipping arrangements than would an outright repeal of Chapter 13.

Taxation of All Generation-Skipping Transfers Not Covered by the $1,000,000 Exemption

Third, subject to the $1,000,000 exemption given each transferor and the other exclusions noted above, the proposal would apply a generation-skipping transfer tax to property when all interests in the property are transferred to or held for the benefit of recipients at least two generations below that of the transferor without the payment of estate or gift tax in an intervening generation. Thus, the GST tax would apply immediately to outright transfers to any person two or more generations below the transferor and to any transfer in trust for the exclusive benefit of one or more such beneficiaries. However, transfers to trusts where a member of the grantor's generation or the generation of the grantor's children has an interest would not be subject to immediate tax. As under present law, the tax in that case would be postponed until actual distributions are made to lower-generation beneficiaries or until all interests in the higher generations terminate, at which time the tax would be imposed on the value of the distributed property or the value of property remaining in the trust. Unlike the present GST tax, though, the proposed GST tax would not provide an exclusion for income distributions. Instead, an income tax deduction would be provided for the GST tax imposed on such income distributions.

Because of the $1,000,000 per transferor exemption and the GST exclusion for lifetime transfers covered by gift tax exclusions, this approach would leave every person free to make substantial gifts or bequests to his or her grandchildren (or any other individual) without the payment of a GST tax at any time. On the other hand, all generation-skipping transfers not covered by the exemptions will be subject to the GST tax. This is an appropriate result since the GST tax is not a penalty on generation-skipping transfers. It merely serves to reduce the bias in favor of generation-skipping transfers inherent in the Federal estate and gift tax system.

Making all generation-skipping transfers subject to Chapter 13 will greatly simplify the GST tax. Under the proposal, it will no longer be necessary to determine if a younger generation beneficiary in a generation higher than some other younger generation beneficiary has an interest or power in a trust sufficient to make it a generation-skipping trust. As a consequence, the "power" rule of present Chapter 13 would be unnecessary. Whether an arrangement is a "trust equivalent" would no longer be relevant, and the concept of the "deemed transferor" would be eliminated.

Technical Explanation

1. Definition of Generation-Skipping Transfer

The proposal would impose a GST tax on all noncharitable transfers which result in the avoidance of the estate and gift tax in one or more generations below that of the transferor. Exceptions are provided, however, for gifts excluded from tax under sections 2503(b) and (e) of the Code and for transfers covered by the $1,000,000 exemption described in section 2 below. An outright gift or bequest, or a transfer in trust where no person in a generation above that of the second generation below the grantor has an interest in the trust, would be subject to GST tax at the time of the transfer. For other transfers in trust, the GST tax would be postponed until actual generation-skipping distributions are made or until the termination of all interests of individuals assigned to generations above the second generation below the grantor. If the trust does not transfer property to a beneficiary two or more generations below the grantor, no GST tax would be payable.

The taxation of direct generation-skipping transfers is an essential part of the proposal for two reasons. First, if all generation-skipping transfers above the $1,000,000 exemption are subject to the GST tax, the tax cannot be avoided by "layering" techniques that pass property, either in trust or outright, directly to the second, third or fourth generation below the transferor. This will eliminate the bias in the current GST tax in favor of the wealthiest families as compared with families of more modest wealth, making the tax fairer and more effective. Second, the comprehensive approach that taxes all generation-skipping transfers not covered by the $1,000,000 exemption or gift tax exclusions has the virtue of simplicity. Any other approach necessarily involves drawing a line between trusts and trust equivalents which are subject to tax and those which are not. This inevitably leads to statutory complexity, which in turn leads to planning difficulties. Only a comprehensive statute can be drawn in a simple and easily understandable way. Finally, a comprehensive statute makes planning easier. Since the GST tax cannot be avoided by certain forms of transfer, the estate planner is no longer in a position to suggest unusual arrangements (such as layering) to save transfer taxes in later generations. Accordingly, tax considerations will be less important in determining an individual's estate plan.

Taxing direct transfers also provides a logical consistency in the proposed GST tax which is lacking in the present system. In general, the proposal assures that a family's accumulated wealth will be taxed once per generation. This consistency makes the system fairer since it assures that families of comparable wealth will have comparable transfer tax burdens, regardless of how their assets are transferred from generation to generation.

An exception to the once-per-generation rule is provided, however, in the case of a transfer which skips more than one generation simultaneously (e.g., a transfer from a taxpayer to his great-grandchild). In such a case, only one GST tax is imposed even though transfer tax in two or more generations is avoided. Also, if property is transferred to a trust, the corpus of that trust cannot be subjected to the GST tax on more than one occasion. This exception will avoid the computational complexity and possibly harsh results which could come from two or more concurrent applications of the GST tax. See Examples 5 and 9 in Section 10 below.

2. $1,000,000 Specific Exemption

Under the proposal, every individual would be entitled to make cumulative transfers, during his lifetime or at death, of up to $1,000,000 without incurring any GST tax. This specific exemption would be similar, although not identical, in operation to the $30,000 specific exemption for gift tax purposes that was available prior to 1977. In particular, a transferor who has not previously used his entire exemption will have the option of using all or any portion of the remaining exemption on a given transfer.

One difference from the pre-1977 gift tax specific exemption, however, would be that a transferor would be free to use his spouse's $1,000,000 exemption against the entire amount transferred, provided the spouse consents, even if the transferor had already used up his own exemption. Moreover, a surviving spouse would be able to apply the unused portion of his or her exemption to any property included in his or her estate (e.g., qualified terminable interest property or property over which he or she holds a general power of appointment).

A grantor of a trust could elect at the time of the transfer of property to the trust or at any time thereafter whether to apply any or all of his exemption to the trust property, even if no GST tax would be payable at that time. The amount of the exemption used would be based on the value of the property at the time of the election, regardless of its value when distributed from the trust. If all property contributed to a trust were covered by an exemption, all distributions from the trust, both during the trust term and upon its termination, would be free from the GST tax. See Example 10 in Section 10 below.

If none of the property contributed to a trust were exempted, all distributions from the trust to a beneficiary in a generation two or more levels below that of the grantor would be subject to a GST tax at the rate described in section 4 below. If a grantor transferred property to a trust whose value exceeded the amount of exemption allocated to the property, the trust would be partially exempt, and each and every generation-skipping distribution from the trust would be partially exempt from tax. The fraction of each distribution exempt from tax would be equal to the ratio of exempt property to total trust corpus, measured at the time of election of the exemption. Additions to a trust subsequent to its creation would require a recomputation of the exemption ratio, based on values at the time of the later contribution. It is anticipated that, for simplicity of administration, many grantors will arrange their affairs so as to have one or more wholly exempt trusts and one or more wholly taxable trusts.

Any portion of the specific exemption not used by a decedent during his lifetime would have to be allocated by the executor on the decedent's estate tax return. Applicable local law should permit the decedent to direct the allocation by will in most cases. If a decedent does not make a specific allocation, however, the executor would then have discretion to allocate the exemption, subject to applicable local law restrictions on the exercise of fiduciary duties. The executor could allocate the unused exemption to property included in the decedent's estate as well as to trusts created by the decedent during his lifetime. Of course, if the value of the decedent's gross estate plus any adjusted taxable gifts made by the decedent is less than the unused exemption, all transfers made and trusts created by the decedent will be exempt from the generation-skipping transfer tax.

3. Elimination of $250,000 Exclusion for Transfers to Grandchildren

It is unclear why transfers to grandchildren should receive more favorable treatment than transfers to other members of that generation (for example, grandnieces and grandnephews). Moreover, in light of the liberal general exemption accorded each transferor, the exclusion for transfers to grandchildren of the grantor will not be needed to avoid the imposition of GST tax on moderately wealthy families. Accordingly, the proposal would eliminate the special $250,000 per deemed transferor exclusion for transfers to grandchildren. Repeal of this exclusion will eliminate the need for keeping records concerning the use of the $250,000 exclusion for transfers attributed to a deemed transferor.

4. Computation of Tax

The tax rate applicable to taxable generation-skipping transfers is equal to 80 percent of the maximum estate tax rate in effect at the time of the taxable event. The maximum estate tax rate is 60 percent for decedents dying in 1983, 55 percent in 1984, and 50 percent in 1985 and thereafter. Accordingly, the GST tax rate will be 48 percent for generation-skipping transfers in 1983, 44 percent in 1984, and 40 percent in 1985 and thereafter.

The GST tax base for a generation-skipping transfer does not include the amount of any estate or gift tax payable with respect to such transfer. On the other hand, in the case of a direct generation-skipping transfer during the transferor's lifetime, the GST tax imposed on the transfer will be treated as an additional gift subject to the gift tax, even though the transferor is primarily liable for payment of the GST tax.

In the case of a taxable direct generation-skipping transfer (e.g., an outright transfer to a grandchild or a transfer to a trust which benefits only the grantor's grandchildren and lower generations), whether by gift or bequest, the GST base includes only the net amount received by the beneficiary. This parallels the tax treatment which would apply if the transfer had been made instead to a member of the skipped generation who then immediately used the property (net of transfer tax) to make a gift to the ultimate recipient and to pay the gift tax thereon. See Examples 3, 6, 7, 9 and 11 in Section 10 below. In all other cases, the GST tax base is equal to the full amount transferred, including the GST tax itself (but excluding any estate or gift tax imposed with respect to the transfer). This accords with the estate tax treatment which would obtain if the transfer had been made instead to a member of the skipped generation who then left the property at death to the ultimate transferee. See Examples 4, 5 and 8 in Section 10 below.

5. Liability for the Tax

Liability for the GST tax would follow the same pattern as the determination of the tax base described above. Thus, in cases where the GST tax is payable immediately upon the initial transfer, the transferor or his executor would be primarily liable for the tax. In all other cases, the transfer would come from a trust and the trustee would be primarily liable for payment of the GST tax.

For any transfer subject to the GST tax, the transferor, executor or trustee would pay the GST tax and distribute only the net amount to the distributee. If the tax were not paid as required, the distributee would be secondarily liable for payment of the GST tax, and any unpaid GST tax would be a lien on the property transferred.

6. Income Distributions

The present Chapter 13 excludes from the term "taxable distribution" any distribution out of the current income of a generation-skipping trust. The exclusion may be defended under present Chapter 13 because of the difficulty of computing the GST tax on income distributions each year. Under the proposal, however, income distributions to lower generations not covered by the $1,000,000 exemption will be subject to GST tax at a flat rate which is easily computed.

Allowing an exemption for income distributions would leave far too great a potential for tax avoidance in multigenerational trusts. For example, if an individual were to fund a discretionary trust for the benefit of his children and grandchildren with income-producing property, the trustee could distribute the income of the trust to the grandchildren each year free from the GST tax and the GST tax on the corpus could be deferred until the death of the last child. This would allow the family to "freeze" the value of the trust property for GST tax purposes at its initial value (since the trust could be invested in debt securities or other assets producing high income rather than capital appreciation) and to defer the payment of GST tax without any offsetting cost. In other words, exempting income distributions would be equivalent to an interest-free loan by the government in the amount of the deferred GST tax.

In view of these considerations, the proposal would eliminate the GST tax exclusion for income distributions. Instead, any GST tax on the distribution, whether paid by the trustee or by the distributee, would be deductible by the distributee for income tax purposes. (If the GST tax is paid by the trustee, the distributee's gross income would include the amount of the GST tax paid.) This deduction would avoid the same amount being subject to both income tax and the GST tax.

7. Limitation on Credit for Tax on Prior Transfers

Section 2013 of the Code provides a credit against the estate tax with respect to property which was subject to estate tax in the 10 years preceding (or the 2 years following) the decedent's death. While this may be a well-founded relief provision in some cases, in others it would allow a GST tax windfall. To prevent this, the proposal generally would deny the section 2013 credit in the event the ultimate recipient of the property is two or more generations below the original transferor. However, a special exception would permit the executor of the second decedent to elect to claim the credit if he also consented to have the two transfers of the property treated together as a single generation-skipping transfer from the first decedent. With this election, the aggregate tax on the two transfers will never exceed the GST tax which would have been imposed if the first decedent had transferred the property directly to the ultimate recipient.

8. Ascertainment of Generation

The present Chapter 13 contains a reasonable and workable set of rules for determining generation assignments. With certain minor amendments, the proposal will retain these rules and incorporate them into the new Chapter 13. The word "grantor," however, would be replaced throughout by "transferor" to reflect the revised focus of the tax.

9. Effective Date

In general, the GST tax imposed under this proposal would apply to all transfers from irrevocable trusts created on or after the date of enactment of the proposal, and to all direct generation-skipping transfers made on or after that date. The proposal would not apply, however, to generation-skipping transfers (either outright or in trust) under wills or revocable trusts of decedents dying before the date which is one year from the date of enactment. The effective date would be extended for testators who are incompetent on the date of enactment. This one-year transition rule will give estate planners time to understand the new rules and to adjust their planning accordingly.

The existing tax on generation-skipping transfers would be repealed retroactively, so that no trust will ever be subject to the provisions of that tax.

10. Examples

The following facts are common to Examples 1-5: T dies in 1984 and leaves his assets to two trusts. The first trust gives the trustee discretion to allocate income and corpus among T's living descendants. T's living descendants are his children, A1 and A2, and his grandchildren B1, B2 (children of A1) and B3 (child of A2). At the later of the death of the survivor of T's children (A1 and A2) or when the youngest of T's grandchildren (B1, B2 and B3) reaches the age of thirty-five, the remaining trust property is to be divided among T's descendants then living, per stirpes.

The second trust is a QTIP trust (i.e., a trust whose property T's executor elects to treat as qualified terminable interest property qualifying for the estate tax marital deduction under section 2056(b)(7)) with income to T's spouse S for life with the remainder outright to A1 and A2 in equal shares. If A1 or A2 should predecease S, his share passes to his issue per stirpes.

T and S have not elected to use any of their $1,000,000 GST tax exemptions on lifetime transfers.

Example 1. T's gross estate is less than $1,000,000. Both trusts are totally exempt from the generation-skipping transfer tax.

Example 2. T's gross estate is $6,000,000. T's will funds the first trust with $1,000,000 and leaves the residuary estate to the QTIP trust. T's executor allocates his $1,000,000 exemption to the first trust. All transfers from this trust are then exempt from the GST tax. If A1 and A2 survive S, no GST tax will be payable with respect to the second trust at S's death.

Example 3. The facts are the same as in Example 2 except that A2 predeceases S. At S's death in 1987, the corpus of the second trust has a value of $5,000,000. Assume that death taxes at S's death payable from the QTIP trust are $1,600,000 so that $3,400,000 remains for distribution to A1 and B3 in equal shares.

Assume that S allocates her entire $1,000,000 GST tax exemption to the $1,700,000 distribution to B3. Thus, $700,000 of the distribution to B3 would be subject to GST tax at a rate of 40 percent. Since the GST tax on the transfer to B3 is payable immediately, the GST tax base applies only to the net taxable amount which passes to B3. To calculate the net amount transferred, simply divide the gross amount ($700,000) by 100 percent plus the applicable tax rate (100% + 40% = 140%): $700,000/140% = $500,000. The GST tax calculation is then straightforward: 40%($500,000) = $200,000. The trustee would be required to pay the $200,000 GST tax, leaving $1,500,000 for distribution to B3.

Example 4. T's gross estate is $10,000,000. T's will directs that his assets be divided equally between the two trusts and that death taxes are to be paid out of the share allocated to the first trust. T applies his entire GST tax exemption to the first trust.

Death taxes are approximately $2,500,000 so that the first trust is funded with $2,500,000. No GST tax is payable when the trust is funded. By virtue of the $1,000,000 exemption, any distributions of income or principal to B1, B2, or B3 are partially exempt from the GST tax. The exempt portion is 40 percent ($1,000,000/$2,500,000) so the taxable portion is 60 percent. As a result, distributions from the trust after 1984 are subject to a GST tax an effective rate of 24 percent (60% x 40%).

Suppose now that A1 and A2 die while the youngest of the grandchildren is still under the age of thirty-five. Even though the property continues in the first trust, at the death of the survivor of A1 and A2 there is a termination of all interests in the trust of individuals in generations above the second generation below T. Hence, all property remaining in the trust (including any accumulated income) is subject to an immediate GST tax equal to 24 percent of the value of such property. Once the tax is paid, however, all future distributions from the trust are free from further GST tax.

Example 5. Assume the same facts as in Example 4 and supppose further that B2 dies before the trust terminates, survived by a single child C (a great-grandchild of T). No additional GST tax is payable at B2's death, when the trust terminates, or when distributions are made to C.

Example 6. In 1985, T makes a gift of $3,010,000 to his granddaughter B and pays any gift and GST taxes due on the transfer. The gift tax annual exclusion applies to $10,000 of the gift, but T does not apply any of his GST exemption to the gift. The $3,000,000 taxable generation-skipping transfer is subject to a GST tax at a 40 percent rate, resulting in a GST tax of $1,200,000. T's payment of the GST tax is treated as an additional transfer subject to gift tax, making the total taxable transfer for gift tax purposes equal to $4,200,000. If T were in the 50% bracket for gift tax purposes, the gift tax would be $2,100,000, the total outlay by T would be $6,310,000, and the net amount received by B would be $3,010,000.

For comparison, suppose T had made a net gift of $6,310,000 to B's parent A who paid T's gift tax liability of $2,100,000 and immediately used the after-gift-tax proceeds of $4,210,000 to make a gift to B and to pay the gift tax on the second gift. If A is also in the top (50%) gift tax bracket, the second gift tax would be $1,400,000 and B would receive a net amount of only $2,810,000.

This example shows that there is some transfer tax saving by using a generation-skipping transfer rather than two successive gifts to transfer the property to B. In contrast, if there were no GST tax, and if T made a net gift of $6,310,000 to B, the gift tax would be $2,100,000 and B would receive a net amount of $4,210,000.

Example 7. T dies in 1985, leaving $8,400,000 in trust for the sole benefit of his grandson B. T is in the top estate tax bracket and T's will allocates death taxes in such a way that $4,200,000 in death taxes are payable out of the bequest to the trust for B. T does not allocate any of his $1,000,000 exemption to this bequest. Since the generation-skipping transfer occurs at the same time as the taxable bequest, the tax applies only to the net amount which passes to the trust for B. As in Example 3, the net amount left in the trust is calculated by dividing the gross amount by 140%: $4,200,000/140% = $3,000,000. The GST tax is 40%($3,000,000) = $1,200,000.

If T had bequeathed the $8,400,000 instead to A (B's parent), A would receive $4,200,000 after estate tax. If A immediately had made a net gift of the $4,200,000 to a trust for B's benefit, and if A were also in the top transfer tax bracket, the trust would receive only $2,800,000, net of a gift tax of $1,400,000. On the other hand, if there were no GST tax, and if T left $8,400,000 in trust for B, the trust would receive $4,200,000.

Example 8. T establishes a discretionary trust for the benefit of his daughter A and his grandson B and funds it with $5,000,000, paying any estate or gift tax due upon the transfer out of other funds. T does not allocate any of his $1,000,000 exemption to the trust. Assume that all income of the trust is distributed currently and that the value of the trust principal does not change.

Any distributions to B are subject to GST tax at a rate equal to 80 percent of the top estate tax rate in effect at the time of the distribution. This is so regardless of whether the amount distributed is less than, equals, or exceeds the annual gift tax exclusion under section 2503(b). If A dies after T but before B in 1985, the $5,000,000 trust corpus is subject to a GST tax of $2,000,000 (40% of $5,000,000), leaving $3,000,000 remaining in trust for B.

Had T made a bequest or gift of $5,000,000 (after transfer tax) to A, and had A bequeathed the property to B in trust at her death subject to estate tax at the top rate, B would receive only $2,500,000. Without any GST tax, B could receive the full $5,000,000 placed in trust by T, free of any further transfer tax.

Comment. Examples 6, 7, and 8 show that the proposed GST tax will significantly reduce the benefits of generation-skipping transfers, whether during lifetime or at death, for transferors in the highest brackets. In no case, however, does the proposal impose a GST tax higher than the transfer tax which would have been paid in the skipped generation had the property passed through that generation.

Example 9. In 1985, T makes a gift of $1,400,000 (before GST tax) in trust for the sole benefit of his great-grandchild C and pays the gift tax thereon out of other funds. T does not apply any of his GST exemption to the transfer. Even though the transfer skips two generations simultaneously, it is subject to only a single GST tax at a rate of 40 percent. Since this is a direct generation-skipping transfer, the GST tax base does not include the tax. Therefore, the balance left in the trust for C is $1,400,000/140% = $1,000,000 and the GST tax is 40%($1,000,000) = $400,000.

Example 10. T has two children, A1 and A2. A1 has a son B1 and A2 has a daughter B2. T establishes two discretionary *inter vivos* trusts, one for the benefit of A1 and A1's descendants, the other for the benefit of A2 and A2's descendants. Each trust is funded with $250,000. T does not allocate any of her GST tax exemption to the trusts at the time they are created.

A1 dies at a time when the trust for her and her descendants has grown to $280,000. T may then decide to allocate $280,000 of her exemption to the trust so that future distributions to B1 will be exempt from the GST tax. If, however, any prior distributions have been made to B1, a GST tax remains payable on such distributions and any tax which has already been paid is not refundable.

Example 11. T dies in 1985, leaving $3,500,000 after estate tax to his daughter A. None of T's $1,000,000 exemption is allocated to this bequest. A makes a qualified disclaimer of the bequest and, as a result, the bequest passes to A's son B. Since the bequest is treated as having passed directly from T to his grandson B, the net amount transferred to B is $3,500,000/140% = $2,500,000 and the GST tax is 40%($2,500,000) = $1,000,000.

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STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
OF THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the views of the Treasury Department on S. 2479, the Section 6166 Technical Revision Act of 1982, which was the subject of hearings held before this Subcommittee on May 27, 1982.

Background

Section 6166 was initially enacted by the Congress in 1958 for the purpose of making it "possible to keep together a business enterprise where the death of one of the larger owners of the business results in the imposition of a relatively heavy estate tax." H. Rep. No. 2198, 85th Cong., 2d Sess. 7. Section 6166 as enacted in 1958 allowed estates whose assets were heavily concentrated in stock or partnership interests in closely held businesses, or in sole proprietorships, to pay the estate tax attributable to those business interests in installments over a 10-year period if the value of the closely held business interests exceeded either 35 percent of the value of the gross estate or 50 percent of the value of the taxable estate. Under the 1958 legislation, interest was charged on the deferred estate tax at the rate of 4 percent per annum, which compared favorably to the 6 percent rate applicable at that time to other unpaid Federal tax liabilities.

In 1975 Congress repealed the special 4 percent interest rate and provided that interest would be charged on estate taxes deferred under section 6166 at the rate generally applicable to tax deficiencies. The 1975 change in the section 6166 interest rate was a part of broader legislation designed to bring the rate of interest charged on unpaid taxes more in line with market interest rates.

The estate tax deferral rules were significantly amended in the Tax Reform Act of 1976, which renumbered the 1958 deferral statute as section 6166A and enacted a new section 6166. The new deferral provision was available only to estates in which the closely held business interest represented 65 percent of the adjusted gross estate (i.e., the gross estate less debts, administration expenses and losses). Thus, the qualification test under the 1976 deferral statute was much stricter than the test under the 1958 statute. However, where the 65 percent requirement was met, the benefits were much more generous. An estate qualifying under the 1976 statute was entitled to pay interest only on the estate tax attributable to the closely held business interest for a period of 4 years after the estate tax return filing date, and then could pay the deferred tax in installments over the next 10 years. In addition, the special 4 percent interest rate was restored for the estate tax attributable to the first $1,000,000 in value of the closely held business interest ($345,800 less the unified credit allowable to the estate).

The Economic Recovery Tax Act of 1981 (ERTA) combined the 1958 statute (section 6166A) and the 1976 statute (section 6166) in a new version of section 6166, which applies to estates of decedents dying after 1981. In general, ERTA incorporated the features of the two preexisting provisions that were most favorable to taxpayers. Thus, the qualification requirement of the 1976 version of section 6166 was dropped from 65 percent to 35 percent of the adjusted gross estate (which generally is a more liberal qualification test than the precentage requirments of either the 1958 statute or the 1976 statute), and the special 4 percent interest rate was made available for the estate tax attributable to the first $1,000,000 in value of closely held business interest in all estates qualifying for deferral.

It is important to note that the special 4 percent interest rate provides, in effect, a substantial estate tax reduction for estates that qualify under section 6166. Assuming a market interest rate of 10 percent, we estimate that the present value of the economic benefit provided by the 4 percent interest rate for qualifying estates of decedents dying after 1986 is approximately $53,000. On the first $1,000,000 of closely held business interest in an estate, this effectively reduces the estate tax liability of $153,000 ($345,800, which is the estate tax on a $1,000,000 taxable estate, less the post-1986 unified credit of $192,800) by almost 35 percent. The benefit of the 4 percent interest rate is even greater if the assumed market interest rate exceeds 10 percent, or if the decedent dies before 1987 and has a lower unified credit. An additional benefit of the section 6166 election is that the interest paid on the deferred tax is itself deductible for estate tax purposes under section 2053. Thus, it is incorrect to assert that section 6166 merely extends the time for payment of estate taxes. Because of the special 4 percent interest rate and the 14-year deferral period, section 6166 effectively provides a substantial estate tax reduction for qualifying estates.

Additionally, in evaluating the desirability of further expanding section 6166, this Subcommittee should note that (i) the deferral benefit may be combined with the benefit of the special use valuation provision of section 2032A in many cases, and (ii) the right to deferred payment under section 6166 is not limited to estates in which there is a genuine liquidity problem. For example, assume that an estate of a decedent dying after 1986 is composed (net of debts, administration expenses and other deductible items) of $675,000 of cash and marketable securities and a closely held business interest with an estate tax value of $675,000. This estate would be entitled under section 6166 to pay 50 percent of its total $241,700 Federal estate tax liability (taking into account the maximum credit for state death taxes), or $120,850, in installments at 4 percent interest over a period of 14 years after the filing of the estate tax return, with interest only payable for the first 4 years. This extraordinary benefit would be available even though the estate has almost 3 times the amount of liquid assets needed to pay the full estate tax liability. Furthermore, the $675,000 closely held business interest in this example could actually be a farm with a fair market value of up to $1,425,000 that qualifies for special use valuation under section 2032A.

Finally, despite the combination of the two preexisting deferral provisions into a single provision in ERTA, section 6166 remains an extremely complex provision of the Code. This complexity makes the provision very difficult for taxpayers and their advisors to understand and for the Internal Revenue Service to administer.

Description of S. 2479

S. 2479, entitled the Section 6166 Technical Revision Act of 1982, is based upon recommendations made by members of an ad hoc task force composed of numerous tax and estate planning practitioners. The bill would make extensive amendments to section 6166 to expand the availability of estate tax deferral and to increase the benefits of the deferral privilege to the estates in which it is available. The proposed amendments fall into 4 general categories: (1) amendments expanding the types of interests in corporations and partnerships, and combinations thereof, that may qualify as an "interest in a closely held business"; (2) changes that increase the ability of estates to dispose of qualifying business interests and to withdraw funds from businesses without accelerating payment of the remaining deferred tax; (3) amendments to change the interest rate for the deferred estate tax in excess of the 4 percent portion and to allow an immediate estate tax deduction for the undiscounted total of the estate's estimated future interest payments; and (4) provisions relating to judicial review of controversies arising under section 6166.

The details of the various proposed changes are described in the pamphlet prepared by the Joint Committee staff for purposes of the May 27 hearing. I should note, however, that the descriptions of the various provisions in the Joint Committee staff pamphlet attempt to make the details of the proposals comprehensible by describing them in fairly broad, general terms. A full appreciation of the enormous additional complexity that would be added to section 6166 by these changes can be gained only by a detailed analysis of all 64 pages of the bill.

The Joint Committee staff has estimated that the revenue loss from S. 2479 would be $476 million in fiscal year 1980 and would increase to $559 million in fiscal year 1986. Treasury agrees with these revenue estimates.

Discussion

The Treasury Department strongly opposes S. 2479. The bill would greatly expand the availability of section 6166 deferral by treating more assets as closely held business interests; it would expand the kinds of qualifying interests that could be aggregated for purposes of meeting the 35 percent qualification test; and it would effectively increase the amounts that could be realized by withdrawals from or dispositions of qualifying interests without accelerating payment of the deferred tax. These changes would greatly expand the availability of and benefits from this special form of estate tax relief, which would cause significant revenue losses and would increase the inequality of treatment suffered by estates that do not qualify for the deferral benefit. Moreover, the bill would extend the existing statute to cover many more cases in which estate taxes pose no real threat to the continuity of a closely held business enterprise.

We acknowledge that S. 2479 identifies some technical problems under current law that should be remedied. Treasury would not oppose a narrowly drafted bill that deals with these technical problems without materially expanding the benefits of the existing statute. We object, however, to other changes in section 6166 that represent merely piecemeal expansion of the effective tax reduction that the present statute grants to qualifying estates. Any material expansion of section 6166 should be considered only in connection with a comprehensive revision of the statute that reduces or eliminates the discrimination against nonqualifying estates resulting from the special benefits of present section 6166.

I will now comment on each major provision of S. 2479.

A. Expansion of Qualifying Business Interests

Under current law, only an interest in (a) a corporation or partnership carrying on an active trade or business in which the decedent holds 20 percent of the voting stock or capital interests ("20 percent ownership test"), (b) a corporation or partnership carrying on an active trade or business with 15 or fewer shareholders or partners ("15 holder test"), or (c) a proprietorship carrying on an active trade or business, will be counted to determine if 35 percent of the adjusted gross estate consists of a qualifying business interest. If two or more separate business interests held by an estate each meet the 20 percent ownership test, those interests may be combined under certain aggregation rules and treated as a single closely held business interest. In determining whether the 15 holder test is met, certain attribution rules provide that indirect ownership is taken into account and that interests held by the decedent's spouse and other family members may be treated as held solely by the decedent. These same attribution rules also may be applied to determine if the 20 percent ownership test is met or in applying the aggregation rules. However, if the estate uses the family attribution rules to qualify for deferral under the 20 percent ownership test or in qualifying for use of the aggregation rules, it cannot use either the 4 percent interest rate or the 4 year interest-only payment period. Moreover, if stock of a corporation is involved, the family attribution rules can be applied for purposes of meeting the 20 percent ownership test and the aggregation tests only if the stock is not readily tradable.

S. 2479 would expand the types of interests that qualify as closely held business interests and would significantly expand the application of the aggregation and attribution rules.

- 1. Interests in Holding Companies. The bill would allow deferral of the estate tax attributable to interests held through certain holding corporations or partnerships carrying on no active trade or business, to the extent that the value of the holding company interest owned by the decedent is attributable to interests held by the holding company which would constitute qualifying closely held business interests if owned by the decedent directly.

We agree that, as a matter of tax policy, there are many cases in which the estate of a decedent who owned a closely held business interest through a holding company should not be denied section 6166 deferral merely because the interest was owned through a holding company rather than directly by the decedent. Indeed, we are now working with the Internal Revenue Service in an attempt to develop regulations under the present statute that treat interests owned through holding companies as qualifying closely held business interests in cases of this type.

Although we may be able to develop regulations under present section 6166 that permit estate tax deferral with respect to interests in holding companies in appropriate cases, legislation may be desirable to clarify when such interests will or will not qualify as closely held business interests. Thus, we would welcome the opportunity to work with this Subcommittee and its staff to draft appropriate legislation to deal with the holding company problem. This legislation should be as simple as possible to understand and administer and should be consistent with the aggregation and acceleration provisions of the statute.

In addition, we are concerned that present section 6166 may be read broadly to permit estate tax deferral with respect to passive investment assets held through corporations or partnerships which carry on some active business directly, regardless of the relative values of the investment assets and business assets of the entity. Section 6166 clearly was not intended to permit deferral of the estate tax attributable to such passive investment assets. Again, we are working with the Internal Revenue Service in an attempt to develop appropriate limitations on such "piggybacking" arrangements in regulations under present section 6166. However, if additional legislation is enacted to make it clear that certain holding company interests may qualify under section 6166, that legislation should deal with the piggybacking problem as well.

2. Treatment of Indebtedness as a Qualifying Business Interest. Under S. 2479, the definition of "interest in a closely held business" would be expanded to include certain indebtedness issued to a decedent before death in exchange for all or part of his interest in what was a qualifying closely held business at the time the indebtedness was issued. Additionally, certain indebtedness owed to the decedent by an otherwise qualifying business in which the decedent held a qualifying equity interest would also be treated as a closely held business interest. Thus, the estate tax attributable to debt interests in qualifying businesses and to notes acquired in predeath buy outs could be deferred under section 6166.

Treasury opposes these provisions for several reasons.

In the case of indebtedness acquired in a predeath buy out, the qualifying business interest has already been sold. Thus, the concern with preventing the sale of a closely held business that underlies section 6166 is not present in such a case. Where an estate contains both debt and equity interests in the same closely held business, a better case might be made for deferral. It may be that, in certain cases at least, the imposition of an estate tax attributable to the value of a debt interest in a closely held business may force a taxpayer to sell his equity interest. Nevertheless, we believe that such a forced sale of the business would not be necessary in most cases, since the debt usually could be refinanced or sold to parties other than the estate without transferring control of the business. Moreover, decisions about the capital structure of a corporation may have been made to minimize income taxes with any adverse estate tax consequences fully taken into account. If it can be shown that our assumptions in this regard are incorrect, we would agree that consideration should be given to treating indebtedness as a closely held business interest where the decedent also owned a qualifying equity interest. In the absence of such a showing, however, we oppose such a change.

3. Treatment of Certain Mineral Interests. The bill would treat as interests in a proprietorship certain operating interests in mineral properties held through partnerships that have the right to elect not to be treated as partnerships for purposes of the income tax rules of Subchapter K of the Code. This would permit a series of such interests to be treated as a single qualifying business interest for purposes of meeting the 35 percent qualification requirement. In addition, the bill would provide that a nonoperating interest in minerals acquired by a decedent in exchange for (a) an operating interest in such minerals or (b) services rendered in connection with locating or acquiring such minerals, would also be treated as a qualifying business interest.

Treasury opposes both these provisions of the bill. In the case of nonoperating interests acquired in exchange for operating interests or services, we believe inclusion of such interests as qualifying business interests would be inconsistent with the purpose of section 6166. Nonoperating interests in mineral properties are essentially passive investments. The estate tax attributable to such passive investments ought not to qualify for a deferral that is intended primarily to prevent the forced sale of active businesses.

The issues raised by the proposed change relating to operating interests in mineral properties held through partnerships eligible to elect out of Subchapter K are more complex. It may be that, given the peculiarities of the oil and gas business, a series of these coownership interests should be treated like a single proprietorship interest rather than as separate interests in different partnerships. Thus, this proposal might properly be viewed as a technical change in the existing statute. On the other hand, we see no reason to treat an estate that holds coownership interests in various mineral properties more favorably than an estate holding numerous coownership interests in other types of property. We also have serious reservations about any change of this sort that would extend the special benefits of the 4 percent interest rate and the 14-year payment period to additional categories of property where it is not clear that the change is purely technical.

4. Assets Leased to Closely Held Businesses. S. 2479 would expand the definition of closely held business interest to include assets that are leased by a decedent to a qualifying closely held business. Treasury opposes this change.

Many of the considerations relating to the treatment of closely held business debt held by an estate owning both debt and equity interests in the business apply equally to property leased by the decedent to a business in which he has a qualifying equity interest. Such leases may have been entered into for income tax planning reasons in full cognizance of the estate planning consequences. Moreover, assets subject to such leases in most cases can be sold to pay estate taxes without forcing the sale of the business to which the assets are leased. Accordingly, we do not believe that section 6166 should be expanded to apply to this type of property.

5. Treatment of Partnership Profits Interests. Under current law, only capital interests in a partnership are counted in determining whether the 20 percent ownership test has been met. S. 2479 would allow profits interests in a partnership to be counted in meeting the 20 percent ownership test.

We view this proposal as a technical change that would not expand the scope of present section 6166 in any significant way. Thus, Treasury does not oppose this provision of the bill.

6. Elimination of Distinction Between Voting and Nonvoting Stock. Under current law, only voting stock may be counted in determining if the 20 percent ownership test is met. The bill would permit nonvoting stock to be used to meet the 20 percent ownership requirement. The proponents of the bill have argued that the change should be made because a nonvoting stock interest can qualify as a closely held business interest if the corporation has 15 or fewer shareholders.

At this time, Treasury neither supports nor opposes this provision of the bill. Nevertheless, we note that the distinction between voting and nonvoting stock is consistent with the concern of Congress to protect family-owned businesses from forced sales of control of the business to outsiders as a result of unexpected estate tax liabilities. These concerns may be less significant where the stock held by a decedent does not carry with it the power to control the enterprise; in many cases, the presence of nonvoting stock in an estate is an indication that control has already been transferred. In contrast, in a corporation with 15 or fewer shareholders, the business is more likely to be disrupted by the death of a shareholder whether or not that shareholder has voting or nonvoting shares.

7. Coordination with Subchapter S. S. 2479 would replace the current 15 holder test with a 35 holder test, so that an interest in a partnership or corporation would be treated as an "interest in a closely held business" if the partnership or corporation has 35 or fewer partners or shareholders. This would bring this portion of the closely held business definition under section 6166 in line with the recent increase in the number of shareholders allowed for corporations electing under Subchapter S of the Code.

We do not believe that the policy considerations underlying the number-of-shareholders limitation in Subchapter S are the same as those involved in the 15 holder test of section 6166. The limitation under Subchapter S is designed to limit pass-through income tax treatment to corporations in which such treatment does not cause undue administrative problems, whereas the 15 holder test in section 6166 is designed to limit the special benefits of estate tax deferral to cases in which the death of a less than 20 percent partner or shareholder may cause an undesirable sale to an outsider to pay the decedent's estate taxes. We are not aware of any reason for liberalizing the 15 holder test in section 6166 other than superficial conformity with Subchapter S. Since this change would represent a significant expansion of present section 6166, we oppose this provision of the bill.

8. Changes in the Aggregation Rules. Under current law, two or more closely held business interests may be aggregated to meet the 35 percent qualification requirement only if each of such interests meets the 20 percent ownership test. S. 2479 would permit aggregation of all business interests meeting the 15 holder test (or, under the bill, the 35 holder test), provided that each business interest so aggregated had a value of at least 5 percent of the adjusted gross estate.

Treasury opposes this provision of the bill. This change would permit deferral in cases where the sale of the decedent's interest poses no threat to the continuation of the business as an independent concern. In an estate that includes less than 20 percent interests in numerous businesses, each interest could be sold without disrupting any of the businesses. Therefore, we do not believe that this provision of the bill is consistent with the underlying policy of the deferral statute, which is to reduce the pressure to sell closely held businesses to pay estate taxes. Furthermore, this change would permit separate investments in numerous partnerships (including tax shelter partnerships) or corporations to be aggregated for purposes of meeting the 35 percent requirement, even though the decedent had no active or substantial involvement in any of the entities. Although the requirement that each such aggregated interest must be equal in value to 5 percent of the adjusted gross estate reduces this concern somewhat, it does not eliminate it.

9. Expansion of Attribution Rules. Current section 6166 has three sets of attribution rules. The application of these attribution rules has different consequences depending on whether the 20 percent ownership test or the 15 holder test is at issue.

Under current law, property held as community property or in joint tenancy, tenancy in common or tenancy by the entirety with a spouse is attributed to the decedent (spousal attribution). Interests held by family members are attributed to the decedent under the rules of attribution contained in section 267(c)(4) (family attribution). Finally, interests held by a corporation, partnership, estate or trust are treated as being owned proportionately by its shareholders, partners or beneficiaries.

For the purpose of determining if the 15 holder test is met, these attribution rules are applied without any effect on the interest rate or payment period for the deferred tax. However, for purposes of determining whether the 20 percent ownership test is met in the case of a single business, or in determining whether two or more interests each meet the 20 percent test for purposes of applying the aggregation rules, the family attribution rules may be applied only if the estate gives up the 4 percent interest rate and the 4 year interest-only payment period. In addition, the family attribution rules may be elected in the case of stock interests for purposes of the 20 percent ownership test only if the stock is not readily tradable. These 20 percent ownership test provisions were enacted in 1978 for the primary benefit of a single family, and the forfeiture of the 4 percent interest rate and the 4 year interest-only payment period was a specific tradeoff for the expansion of the deferral privilege.

S. 2479 would (a) eliminate the penalty for use of the family attribution rules in the case of the 20 percent ownership test and aggregation rule, (b) include spouses of a decedent's brothers, sisters and lineal descendents within the scope of the family attribution rules, and (c) include estates of family members within the family attribution rules.

Treasury opposes these extensions of the attribution rules. We oppose elimination of the penalty for use of the family attribution rules in meeting the 20 percent ownership test and aggregation rules for two reasons: (1) we are opposed in general to the extension of the effective tax reduction to new classes of taxpayers; and (2) we believe that the compromise worked out in 1978 should not be undone. In fact, attribution for purposes of meeting the 20 percent ownership test permits businesses to qualify for deferral where the actual interest of the decedent in a business may be minimal, where the interest held by the extended family in the business may be less than a controlling interest, and where transfers reducing the decedent's interest below 20 percent may have been motivated by estate tax planning considerations. Such taxpayers ought to be entitled to deferral, if at all, only if no effective estate tax reduction accompanies the deferral. Moreover, we believe that expansion of the entity or family attribution rules would be inconsistent with other provisions of the Code, such as section 267(c)(4), and would permit a business interest to qualify for section 6166 purposes where the 20 percent ownership interest is widely diffused among an extended family group.

B. Expansion of Acceleration Exceptions

Under current law, withdrawals or dispositions of more than 50 percent of the value of the decedent's interest in a qualifying business will trigger an acceleration of any estate tax liability deferred under section 6166. This is necessary because the purpose of sectin 6166 is to prevent an involuntary disposition of a closely held business interest to pay Federal estate taxes.

This purpose is no longer served after more than one-half of the estate's interest has been liquidated. S. 2479 makes several changes to section 6166 that would permit certain withdrawals or dispositions of a business to occur without counting against the 50 percent withdrawal or disposition ceiling.

First, S. 2479 would provide that the exchange by an estate of qualifying stock or partnership interests for indebtedness of the corporation or partnership, or for certain debt of other partners or shareholders that is guaranteed by the business entity, would not be treated as a withdrawal or disposition so long as the notes received were not readily tradable, or the enterprise was not sold to a corporation whose stock was readily tradable.

We oppose this provision of the bill. Once a business interest is exchanged for debt, concerns about preventing a forced sale of the business no longer apply with the same force because the estate has voluntarily disposed of the decedent's equity in the business. Furthermore, this change would significantly expand the scope of present 6166 and would give taxpayers an unwarranted incentive to use debt rather than cash payments in postdeath buy out arrangements to obtain the benefit of the 4 percent interest rate.

Second, under current law, redemptions under section 303 do not count as withdrawals or dispositions for purposes of the acceleration rules if the proceeds of the redemption are used to pay Federal estate taxes. Rather, the value of the qualifying business interest is reduced by the amount of the redemption proceeds so used. The bill would expand this current exception to include section 303 redemptions used to pay funeral or administration expenses, state death taxes, or interest on Federal estate taxes, and to partnership or proprietorship withdrawals used for such purposes.

We support these changes insofar as they permit withdrawals or dispositions to pay interest on Federal estate taxes without triggering acceleration, and insofar as they would create an exception analogous to the section 303 exception for cases in which funds obtained from partnership or proprietorship withdrawals or dispositions are used to pay Federal estate taxes or interest on such taxes. We believe the section 303 exception should apply to funds used to pay interest on Federal estate taxes as well as to funds used to pay the principal amount of the tax. Otherwise, the acceleration provisions could cause an estate to lose the deferral privilege even though all amounts obtained from the withdrawals or dispositions have been paid over promptly to satisfy obligations arising directly from the Federal estate tax. The section 303 exception also should be extended to partnership and proprietorship withdrawals and dispositions to avoid discrimination against those forms of business in the application of the acceleration rules. However, we oppose the modifications of the acceleration rules that would disregard distributions or withdrawals used for normal administration expenses, funeral expenses, or state taxes. Once withdrawals or dispositions to pay Federal estate taxes and interest are disregarded, the 50 percent allowance for other withdrawals and dispositions provides ample leeway for estates to liquidate interests to meet their other liquidity needs.

Third, under current law, an exchange of qualifying stock in a reorganization described in subparagraph (D), (E) or (F) of section 368(a)(1) or in an exchange to which section 355 applies is not treated as a disposition for purposes of the acceleration rules. S. 2479 would expand this rule to exchanges of stock in reorganizations described in section 368(a)(1)(A), (B), (C) or (G), provided the stock received in any such exchange is that of a closely held business. Similarly, in general, no disposition or withdrawal would occur as a result of a section 1031 like-kind exchange or as a result of the surrender of a qualifying interest in an involuntary conversion under section 1033.

Treasury opposes these provisions of the bill. We believe that current law is correct in distinguishing between nonacquisitive reorganizations involving exchanges of qualifying stock, on the one hand, and tax free exchanges or distributions of stock or other assets that involve dispositions or divisions of the qualifying business interest, on the other hand. In a D, E or F reorganization or a section 355 exchange, an estate does not exchange its stock for stock in a different enterprise. In contrast, in acquisitive reorganizations, like-kind exchanges or involuntary conversions, the opportunity generally exists to cash out the interest held by the estate and to receive funds to pay the tax; in any event, such transactions generally result in transfer of control of the business to different parties. Once the estate's assets cease to be tied up in the original closely held business, the rationale for permitting the deferral ceases. We believe the present rules correctly provide an exception to the acceleration rules only in reorganizations where there is complete continuity of ownership in the business.

The bill also would provide that no acceleration will occur as a result of the death of the initial legatee or heir of the qualifying business interest, even if the result is that the interest passes outside of the initial decedent's family. This changes current law, which provides for no acceleration only if the qualifying business interest passes to family members upon a second death. This aspect of the bill is consistent with the purpose of section 6166 and would not materially expand the deferral provision. Thus, Treasury has no objection to this change.

C. Treatment of Interest on the Deferred Tax

Under current law, interest payments made under section 6166 are generally deductible as administration expenses when paid or accrued. The deduction follows from the Tax Court's decision in Estate of Bahr v. Commissioner, 68 T.C. 74 (1977), which rejected the contrary position taken by the IRS in Rev. Rul. 75-239, 1975-1 C.B. 304 (which ruling was based on the decision in Ballance v. United States, 347 F.2d 419 (7th Cir. 1966)). However, the position of the Internal Revenue Service is that such interest is deductible only when paid. The estate tax deduction for the interest creates a circular computation since the interest when paid reduces the estate tax liability, which in turn requires a recomputation of the outstanding deferred amount, and so on.

S. 2479 would deal with this problem by permitting an estate tax deduction for the interest under section 2053 in an amount equal to the total projected interest to be paid on the entire deferred amount. The amount of the estate tax deduction would not be discounted to reflect the fact that the interest would be payable over a 14-year period in the future. In addition, the rate of interest on the tax in excess of the amount qualifying for the 4 percent rate would be changed to a rate that is tied to the average yield to maturity of Treasury obligations with a remaining term of 14 years.

Treasury strongly opposes these provisions of the bill. We agree that something should be done about the circularity problem. However, the course chosen by the bill has the effect of permitting a current deduction in full for interest that will not be paid until up to 14 years in the future. Such a tax benefit, which would be in addition to the substantial effective tax reduction already provided by the 4 percent interest rate of the existing statute, is totally unwarranted. Moreover, because this full deduction for interest payable will reduce the value of the decedent's adjusted gross estate, but not the value of the qualifying business interest in that estate, the effect will be to increase substantially both the number of estates qualifying for deferral and the percentage of estate taxes that may be deferred in all qualifying estates.

In lieu of this approach, we suggest that the circularity problem should be eliminated by denying any estate tax deduction for interest paid with respect to estate taxes deferred under section 6166. This change would simply offset part of the benefit of the 4 percent interest rate. Moreover, it would restore the rule that was followed in this area by the Internal Revenue Service (which was accepted by most taxpayers and, presumably, by the Congress) when the 4 percent interest rate was enacted in the Tax Reform Act of 1976. Of course, interest on the deferred tax would continue to be deductible for income tax purposes.

D. Judicial Review

Under current law, no judicial review is provided for controversies as to whether an estate qualifies for section 6166 deferral, or as to whether acceleration is required as a result of withdrawals or dispositions of qualifying business interests.

S. 2479 would provide a declaratory judgment proceeding in the Tax Court for review of disputes concerning the eligibility of estates for deferral and the application of the acceleration rules. Decisions of the Tax Court would be appealable. Penalties against taxpayers who instituted such actions primarily for delay could be imposed by both the Tax Court and the Court of Appeals.

In general, Treasury supports judicial review of controversies involving section 6166 and believes that the Tax Court is the appropriate forum. Care should be taken, however, to insure that the proposed declaratory judgment procedure will not lead to premature litigation of valuation questions and other issues that may be involved in the estate tax audit. In addition, careful consideration should be given to the question of whether the allowance of appellate review of Tax Court declaratory judgments under section 6166 will permit estates to obtain unwarranted de facto deferral in many cases.

* * *

This concludes the statement of Treasury's position on S. 2479. We look forward to working with the Subcommittee as it considers these and other proposals to amend the estate tax deferral rules.

Senator SYMMS. Thank you very much, Mr. Woodward. Immediately preceding your statement I would like to ask unanimous consent that the statement of Senator Malcolm Wallop will be put in the record, and I might just comment, it is a very excellent statement. Senator Wallop said that his No. 1 priority in his mind is not necessarily the passage of new legislation but the preservation of legislation we passed as part of the Economic Recovery Tax Act of 1981, which may be in very real danger of being partially repealed.

In view of your testimony this morning where Treasury has pretty much consistently opposed these, what I believe are very essential corrections to the estate tax law, you did say, so we can end this on a positive note, you did say that you still favor the 1981 Recovery Act of what we got passed. I think I heard you say that.

Mr. WOODWARD. Absolutely, Mr. Chairman, and I think that that is clearly the most significant aspect of our testimony today.

Senator SYMMS. Thank God we got it passed then, in view of the record we have with these bills here this morning.

Mr. WOODWARD. We will agree with you on that subject.

[The prepared statement of Senator Wallop follows:]

STATEMENT OF SENATOR MALCOLM WALLOP

I would like to thank Senator Symms for scheduling this hearing this morning. In light of the budget resolution and the revenue targets it contains, this hearing could not be more timely. I have a very specific interest in several of the bills and resolutions being considered here today. The repeal of the generation skipping tax, the improvement of section 6166 rules for the installment payment of estate taxes, and equitable gift disclaimer treatment all deserve the favorable action of the Finance Committee. However, the number one priority in my mind is not the passage of new legislation but the preservation of legislation we passed as a part of the Economic Recovery Tax Act of 1981, and which may be in very real danger of being partially repealed.

I do not have to remind anyone here of the importance of the gift and estate tax changes we made in 1981. I was very proud to have played a very active role in the enactment of those changes. As a part of the 1981 law we eliminated the "widow's tax." Under the old estate tax law, a farm wife found that not only did she have to pay estate taxes, but that it was nearly impossible to prove to the IRS her own significant financial contribution to the operation of the ranch or farm. After years of pouring her sweat and blood into the operation of the ranch as a full partner, the wife felt the totally insulting and unfair tax treatment that fell her way by operation of the estate tax laws. We have corrected that by removing all limitation on the marital deduction for estate and tax purposes.

In addition, we were able to increase the unified credit to an equivalent of $600,000 when fully phased in. The maximum rate will be reduced to 50 percent. The installment payment of taxes for closely held businesses was liberalized together with the current use valuation for farm and ranch property. But now, the budget passed by the Congress has made it clear that this body has refused to curb its appetite for spending more and more dollars which we simply don't have. Instead of cuts in spending, this Committee has been asked to raise $73 billion, 12 of which must come next year. That deliberate choice now means that the great progress we have made in gift and estate tax changes may be in jeopardy.

Several months ago, the Chairman of the House Ways and Means Committee suggested that any tax reductions which are not effective by the end of this year should be repealed. The so-called "freeze" proposal would provide a maximum eatate and gift tax credit of $275,000, less than half of the $600,000 in relief this Congress promised our nation's ranchers, farmers, and small businessmen just two years ago. In addition, the maximum tax rate would be frozen at 60 percent, well short of the promised 50 percent maximum rate.

But all of this has not gone unnoticed. Two months ago, I introduced a sense of the Senate resolution which sought to reaffirm the commitment we made to the family ranchers and farmers who produce the food we eat, and our small businessmen and women who create the majority of the new jobs in this nation. Senate Resolution 126 expresses the sense of the Senate that the gift and estate tax reductions made in 1981 are vital to the continuation of family farms, ranches, and small businesses and that the reductions scheduled to become effective after this year should not be modified or repealed. I am happy to report that several of my colleagues have joined me in that effort. As of today there are 31 cosponsors, 32 including myself, of Senate Resolution 126.

It is my hope that the support that has been shown for this resolution will send a very strong message to my colleagues on both sides of the hill that we simply cannot and will not tolerate any attempt to balance the budget on the backs of those individuals who work so hard to feed this nation, to provide jobs in our economy, and to provide stability in our society.

Senator SYMMS. OK. Thank you very much. I appreciate your testimony.

Our next witnesses will be Mr. Robin Swift and Mr. Ray Stroupe. I might just say that all statements will be printed and will be a part of our record. So I ask unanimous consent that all witnesses' entire statements be part of the record. I would say to the witnesses that if they can keep their testimony to within 5 minutes, it would be greatly appreciated, I am sure not only by the chair but by the many, many people that have come in from around the country to testify that are patiently waiting to have their chance to get their remarks before the committee.

Mr. Swift.

STATEMENT OF G. ROBIN SWIFT, JR., PRESIDENT, SWIFT LUMBER, INC., ON BEHALF OF THE AD HOC COALITION ON ESTATE TAXATION

Mr. SWIFT. Good morning, Mr. Chairman. My name is Robin Swift. I am president of Swift Lumber Co. of Atmore, Ala., a small family-owned lumber manufacturing concern.

I appreciate the opportunity to be here today to testify on behalf of the Ad Hoc Coalition on Estate Taxation. This coalition had its roots back in 1981. At that time our various member associations met to coordinate their position on estate and gift tax return prior to testifying before this subcommittee.

Earlier this year we again convened the group because some in Congress are threatening to take away the gains we made in 1981 and because much is still needed by way of estate and gift tax return.

Mr. Chairman, we hope that through our coordinated approach, we may again provide the committee assistance in making our estate and gift tax laws more equitable to all Americans. Mr. Chairman, we appreciate your leadership in this effort.

The subcommittee's 1981 hearings, which filled more than 900 pages of printed record, amply documented the substantial need for estate and gift tax reform. Based on those hearings, this committee approved legislation ultimately incorporated in the Economic Recovery Tax Act of 1981, which provided substantial reductions in estate and gift taxes. These reductions, however, are to be phased in over several years.

When the estate tax reductions made by ERTA become fully effective, we will have made some progress toward reducing the adverse economic effect of estate and gift taxes. This is not to say, however, that additional improvements to the estate and gift tax laws are not required. The current tax remains inefficient, as it discourages capital-intensive investments. Capital-intensive investments which offer the greatest potential for economic growth are characteristically illiquid, as they include factories and equipment. Because of the substantial tax that may be imposed upon death, those in the best position to make meaningful capital investments are encouraged instead to make investments in liquid assets, with which their estate taxes might more easily be paid.

The estate tax also remains inequitable as it favors consumption over savings. The taxpayer who consumes his earnings has no estate and hence, no estate tax liability. The taxpayer who saves his earnings, however, acquires an estate and is thus subject to the estate tax. Our tax policy is backwards. It should encourage rather than discourage savings.

Mr. Chairman, there is a further inequity in that the very survival of many small, family-owned businesses is threatened by estate taxation at the passing of each generation. Unlike publicly held corporations which never die, at least in an estate tax sense, we as owners of small businesses must continually plan for the next division of assets with Uncle Sam.

I would suggest that this situation is not good, not good for the encouragement of new ventures, not good for the employment of our people, and not good for the vital spirit of free enterprise that has distinguished this Nation's economy.

In spite of all this, some Members of Congress are now proposing to free estate and gift taxes at current levels. The reasons supporting the reductions scheduled by ERTA in estate and gift taxes are as valid today as when ERTA was first enacted.

We thus applaud you, Mr. Chairman, and the other sponsors of Senate Resolution 126 which expresses the sense of the Senate that the scheduled estate and gift tax reductions should be permitted to go into effect and should not be frozen.

We also support S. 1252, which would repeal the generation-skipping transfer tax. This tax, which is not needed for revenue, is unduly complex. While Treasury has recently come forward with a proposal to further modify the tax, the merits of Treasury's proposal require substantial study, as it is seeking to modify what for several years has remained an unfathomable tax law. Because of this unnecessary complexity, we would urge the immediate repeal of this tax.

Due to concern over deficits, we recognize it may not now be an appropriate time for implementation of further estate and gift tax reductions. Nevertheless, because of continuing inefficiency and inequity of the current tax system, we would urge, when the timing is appropriate, that the maximum estate and gift tax rates be reduced to 20 percent, and that pro rate reductions be made for all rates. Were the tax reduced to this level, its adverse effect on capital investment and savings would be significantly reduced.

Also, we urge the indexing of the unified credit. In making this recommendation, however, we recognize that if the indexing of entitlements is abandoned, this proposed indexing of the unified credit might be inappropriate.

We also believe that section 6166 of the Code should be revised to eliminate uncertain and awkward procedures for paying estate taxes in installments. The provisions of S. 1251 provide a sound basis for addressing these problems.

Finally, we would support several amendments to the current use valuation provided by section 2032A; first, because subsection——

Senator **Bentsen** [presiding]. Mr. Swift, your time has expired. I will ask you to sum it up in very short order if you will, please. We will take your entire statement into the record, but we obviously have a long list of witnesses.

Mr. **Swift**. Thank you, Senator.

Mr. **Bentsen**. The trouble is, it is all good, isn't it? It is just hard to cut it down.

Mr. **Swift**. It is kind of hard to separate the wheat from the chaff that quick. Thank you.

[The statement of G. Robin Swift Jr. follows:]

STATEMENT OF

G. ROBIN SWIFT, JR.
PRESIDENT
SWIFT LUMBER, INC.

ON BEHALF OF THE

AD HOC COALITION ON ESTATE TAXATION

BEFORE THE

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

COMMITTEE ON FINANCE

UNITED STATES SENATE

WASHINGTON, D. C.

JUNE 27, 1983

I. Introduction

Good morning Mr. Chairman and Members of the Subcommittee. I am delighted to be here today to testify on behalf of the Ad Hoc Coalition on Estate Taxation. Members of the Coalition supporting this statement are listed on Appendix A.

This Coalition had its roots back in 1981. At that time, our various member associations met to coordinate their position on estate and gift tax reform, prior to testifying before this Subcommittee. Earlier this year, we again convened the group because some in Congress are threatening to take away the gains we made in 1981 and because much is still needed by way of estate and gift tax reform.

Not surprisingly, our members include many organizations comprised of individuals who own their business, as it is these persons and their families who are most severely impacted by the imposition of the estate and gift taxes.

Mr. Chairman, we hope that through our coordinated approach, we may again provide the Committee assistance in making our estate and gift tax more equitable to all Americans.

II. Background

This Subcommittee's 1981 hearings, which filled more than 900 pages of printed record, amply documented the substantial need for estate and gift tax reform. Those hearings included statements from many of those who you are hearing from today, including owners of small businesses, agricultural enterprises, livestock, and timber. In addition, those hearings included statements both from tax professionals and economists describing the need for estate and gift tax relief.

Based on those hearings, this Committee approved legislation, ultimately incorporated in the Economic Recovery Tax Act of 1981 (ERTA), which provided substantial reductions in the hardships caused by the estate and gift tax.

ERTA increased the credit that might be applied to estate and gift taxes, the effect of which was to increase the exclusion from $175,600 for decedents dying prior to 1981 to $600,000 for decedents dying after 1986; it reduced the maximum estate tax rate from 70 percent for decedents dying prior to 1981 to 50 percent for decedents dying after 1984; it provided an unlimited marital deduction; it improved the special use valuation; it increased the annual gift tax exclusion; and it made other, more technical, improvements.

When the increase in the credit and the decrease in the maximum rate become fully effective, we will have made substantial strides toward reducing the adverse economic effects of the estate and gift tax regimes. This is not to say, however, that additional estate and gift tax relief is not needed.

III. Analysis of Current Estate and Gift Tax

Despite the ERTA amendments, additional improvements to the estate and gift tax are required. Some of these, which have an insubstantial revenue impact can be made now; others, with a greater revenue impact, might be required to be postponed until our Nation's deficits are better under control.

To understand why additional estate and gift tax relief is needed, however, an overall evaluation of the fairness of estate and gift tax may be helpful. This might be accomplished by considering the tax's efficiency and equity. We believe that despite the ERTA amendments, the estate and gift tax continues to be both inefficient and inequitable.

The current tax is inefficient as it discourages capital intensive investments. Capital intensive investments, which offer the greatest potential for economic growth, are characteristically illiquid as they include factories and equipment. Because of the substantial tax that may be imposed upon death -- up to 50 percent after 1985, 60 percent today -- those in the best position to make meaningful capital investments are encouraged, instead, to make investments in liquid assets with which their estate might easily satisfy their estate tax obligations. Thus, at current levels, the estate tax continues to frustrate our national goals of stimulating capital expenditures.

The estate tax is also inequitable as it favors consumption over savings. Two otherwise equally situated taxpayers -- one spending all that he earns, the other saving as much as possible -- are taxed dramatically differently upon their death. The taxpayer who consumed his earnings has no estate, and no estate tax. The taxpayer who saved, however, is subject to an estate tax as a result of having acquired an estate.

Our tax policy should encourage, rather than discourage, savings. To the extent that it continues to discourage savings, we will not achieve the reinvestment in our nation's productive enterprises that is necessary if our economy is to prosper.

In this regard, it is worth noting that the estate and gift tax is justified by the assumption that the rate of savings is not affected by such tax. This assumption, however, is not true. A key motive underlying the savings of many persons is the desire to pass an estate on to one's heirs and beneficiaries. The desire to leave savings to others is made manifest by empirical evidence indicating that the great majority of accumulated wealth in the United States is transferred from generation to generation. Thus, most savings is eventually conveyed to others; it is not consumed during the saver's lifetime.[*/]

IV. Where We Are Today

A. S. Res. 126

Despite the continued need for further improvements in the estate and gift tax, some members of Congress are proposing to freeze estate and gift taxes at current levels. Under such proposals, the credit would be frozen at an effective exclusion of $275,000; it would not be permitted to increase to an effective exclusion of $600,000. And the maximum rate would be frozen at 60 percent; it would not be permitted to decline to 50 percent.

The reasons supporting these scheduled estate and gift tax reductions are as valid today as when ERTA was first enacted. We thus applaud the sponsors of S. Res. 126, which expresses the sense of the Senate that the scheduled estate and gift tax reductions should be permitted to go into effect and should not be frozen.

[*/] These views on the impact of the estate tax also have support in the economic community. *See, e.g.*, Testimony of David Raboy, Institute for Research on the Economics of Taxation "Major Estate and Gift Tax Issues", Hearing before the Subcommittee on Estate and Gift Taxation, Committee on Finance, United States Senate, 97th Cong., 1st Sess. 119-136 (1981).

B. S. 1252

We also support S. 1252, which would repeal the generation skipping transfer tax (GSTT). This tax, which is not needed for revenue, is unduly complex. While Treasury has recently come forward with a proposal to further modify this tax, the merits of Treasury's proposal require substantial study as it is seeking to modify what for seven years has remained an unfathomable tax regime. Because of this unnecessary complexity, we would urge the immediate repeal of the GSTT.

Without commenting on Treasury's proposal in detail, we note that it could impose a tax of up to 110 percent on a taxpayer who had exhausted both his unified credit and proposed generation skipping tax exemption: Were a taxpayer who was subject to a 50 percent unified tax rate to give $1 million to a grandchild, he would be subject to a total tax on the transfer of $1.1 million: a generation skipping transfer tax of $400,000 and a gift tax of $700,000 (computed on the amount of the GSTT added to the amount of the gift).*/ We believe that such results are totally unacceptable.

We would thus urge that the Treasury's proposal not delay the immediate repeal of the generation skipping transfer tax.

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*/ The example disregards the $10,000 annual exclusion.

C. Further Improvements in Estate and Gift Tax

Because of the concern over deficits, we recognize that now may not be the appropriate time for implementation of further estate and gift tax reductions. Nevertheless, because of the continuing inefficiency and inequity of the current estate and gift tax system, we would urge, when the Subcommittee deems it appropriate, that the maximum estate and gift tax rate be reduced to 20 or 30 percent, and that pro rata reductions be made for all rates. Were the tax reduced to these levels, its adverse effects on capital investment and savings would be significantly reduced.

Also, we would urge the indexing of the unified credit. In making this recommendation, however, we recognize that were the indexing of entitlements abandoned, this proposed indexing of the unified credit might be inappropriate. Nevertheless, since indexing currently is a part of both the income tax laws and the entitlement programs, we would urge its extension to the estate and gift tax area.

We also believe that Section 6166 of the Code should be revised to eliminate uncertain and awkward procedures for paying estate taxes in installments. Although ERTA made a number of significant and beneficial changes in the availability and operation of Section 6166, the provision remains unduly complicated and restrictive. The provisions of S. 1251 provide a sound basis for addressing these problems and we encourage your efforts in revising and clarifying his provision.

Finally, we would support amendments to the special use valuation provided by Section 2032A. Because subsection (e)(7) is inapplicable to many estates, and because of the difficulty and uncertainty in applying subsection (e)(8), we would urge that a "safe-harbor" be added to this section as an optional alternative to these other methods of valuation. This safe-harbor would permit qualified property to be valued at 50 percent of its fair market value at the time of death -- a determination much more easily made. Such a safe-harbor is consistent with the valuations now available under subsection (e)(7) and (8), which we understand are in the range of 40 to 70 percent of fair market value.

Further, estates with businesses without substantial holdings of real property are unable to use the special use valuation, as there is no real property to specially value. Nevertheless, often these businesses are subject to the same liquidity problems as estates with businesses owning real property. And the imposition of the estate tax on such estates results in the forced sale of their businesses. We would thus urge that closely-held business property be made eligible for the special use valuation so that businesses without real property could avail themselves of the 50 percent "safe-harbor".

Additionally, while the ceiling on the amount of property eligible for the special use valuation was increased by ERTA from $500,000 to $750,000, this is woefully inadequate. Many small businesses own property valued far in excess of this amount. Accordingly, we would urge the removal of the $750,000 ceiling altogether.

Finally, it is not clear under current law whether an election to use a particular method of valuation is irrevocable. Because of disputes that may arise in audit concerning certain aspects of formula valuation, it may be advantageous for an executor to change his method of valuation. As a solution to this problem, we suggest allowing an executor to change his method of valuation on an amended return at any time before the statute of limitations for assessing additional estate tax has run.

Mr. Chairman, that concludes my statement. I would be pleased to answer any questions that you may have.

APPENDIX A

AD HOC COALITION ON ESTATE TAXATION MEMBERS SUPPORTING THIS STATEMENT

American Bankers Association

American Horse Council

Association of General Contractors

Forest Farmers Association

Forest Industries Committee on Timber Valuation and Taxation

National Association of Conservation Districts

National Association of Home Builders

National Association of Wholesaler Distributors

National Cattlemen's Association

National Committee to Preserve Family Business

National Cotton Council of America

National Family Business Council

National Forest Products Association

National Milk Producers Federation

National Realty Committee

National Retail Merchants Association

National Small Business Association

National Wheat Growers Association

Small Business United

Southeastern Lumber Manufacturers Association

Southern Forest Products Association

United Egg Producers

U. S. Chamber of Commerce

Senator **Bentsen**. All right, sir, if you would proceed. Give your name for the record, please.

STATEMENT OF RAY M. STROUPE, PRESIDENT, NATIONAL TAX EQUALITY ASSOCIATION, WASHINGTON, D.C.

Mr. **Stroupe**. Mr. Chairman, I am Ray M. Stroupe, president of the National Tax Equality Association, NTEA, and I am accompanied by Edward N. Delaney II, director of research. The association we speak for is composed mainly of small enterprises which oppose excessive and discriminatory taxation of business and capital. We appreciate the opportunity to appear here in support of a tax policy that will continue to permit owners of farms and small businesses to transfer these properties to the next generation without subjecting the inheritors to the burden of an extremely high level of taxes.

In 1981, NTEA appeared before the Subcommittee on Estate and Gift Taxation in support of S. 404, a bill to repeal estate and gift taxation. We stated our view that such taxation is a counterproductive feature of the tax code, and we added that disincentives to investment and entrepreneurial activity are very great, relative to the revenues derived from estate and gift taxes.

Even though the Congress did not give its approval to total elimination of estate and gift taxes, it did endorse highly significant legislation providing for substantial tax reductions to be phased in during the next few years. We were gratified to see that these scheduled reductions were enacted into law as part of the Economic Recovery Tax Act of 1981. This action was a valuable step toward the removal of tax discrimination against the owners of family farms and businesses who expect to obtain the full benefits of the relief provided in the 1981 law.

The changes that the Congress made in estate and gift taxation were made partly because of high inflation that had increased the value of many estates that included small businesses and farms, forcing the sale of these businesses to meet tax obligations. Modifying the 1981 changes in a manner that would eliminate further increases in the unified credit would mean that relief would be limited to estates of $275,000 or less.

This rate simply does not account for the great inflation experienced from 1976 to 1980, when the GNP deflator reached 10.5 percent. Additionally, the administration expects a Consumer Price Index of 4.4 percent for 1984, sustaining inflated business valuation and raising concerns that over a number of years, estate values will increase further.

Another primary concern motivating the 1981 changes centered on the economic inefficiency caused by the estate tax, distorting business decisions. Increased estate taxes at this time will contribute to inefficiency at the worst moment possible. We are beginning to witness economic recovery, and this recovery can only be aggravated if small business owners turn their attention to tax avoidance schemes that limit capital investment and saving.

Also, any saving that does take place would not be in the form of productive investment because of the liquidity need to meet high estate tax obligations. Small business owners and managers need predictability in the tax code to allow them to improve their own business conditions, thereby contributing to recovery.

The estate tax discriminates against 2.5 million small businesses and family farms because it does not apply to publicly held corporations. Consequently, in conformity with our efforts to promote equity in the tax code, we support Senate Resolution 126, which expresses the sense of the Senate that the 1981 changes should not be modified.

Thank you, Mr. Chairman, for the opportunity to present this abbreviated statement.

[The statement of Mr. Stroupe follows:]

STATEMENT OF RAY M. STROUPE, PRESIDENT

NATIONAL TAX EQUALITY ASSOCIATION

Mr. Chairman, I am Ray M. Stroupe, President of the National Tax Equality Association (NTEA), and I am accompanied by Edward N. Delaney II, Director of Research. The association we speak for is composed mainly of small enterprises which oppose excessive and discriminatory taxation of business and capital. We appreciate the opportunity to appear here in support of a tax policy that will continue to permit owners of farms and small businesses to transfer these properties to the next generation without subjecting the inheritors to the burden of an extremely high level of taxes.

In 1981, Mr. Chairman, NTEA appeared before the Subcommittee on Estate and Gift taxation in support of S. 404, a bill to repeal estate and gift taxation. We stated our view that such taxation is a counterproductive feature of the tax code, and we added that disincentives to investment and entrepreneurial activity are very great, relative to the revenues derived from estate and gift taxes.

Even though the Congress did not give its approval to total elimination of estate and gift taxes, it did endorse highly significant legislation providing for substantial tax reductions to be phased in during the next few years. We were gratified to see that these scheduled reductions were enacted into law as part of the Economic Recovery Tax Act of 1981. This action was a valuable step toward the removal of tax discrimination against the owners of family farms and businesses, who expect to obtain the full benefits of the relief provided in the 1981 law.

While these benefits are distributed among various provisions of the 1981 law, two provisions make up the bulk of the tax reductions. Also, these provisions are fundamental in their contribution to a fairer, more efficient estate tax policy. The provisions I refer to include the increase in the unified credit and the reduction of the maximum tax rate from 70% to 50% over a four-year period.

The law increases the unified credit from $47,000 to $192,000 over a six year period in an effort to address the increasing estate and gift taxation burdens due to inflation. High inflation reduced the value of the credit and forced estates and gifts into higher transfer tax brackets.

The Congress determined that the $47,000 credit in effect until 1981, was an amount too low to provide relief for estates containing farms and small businesses. Many businesses were forced to sell out to meet their tax obligations, which was a condition directly conflicting with previously expressed tax policy goals avoiding business concentration. This year, the credit is $79,300, which provides relief for transfers totaling $275,000 or less. We urge the Congress to retain the current schedule that will reach exemption for $600,000 estates in 1987, and to monitor the unified credit for further adjustments to future increases in price levels.

The economic conditions that required the 1981 tax law changes persist, and we believe these conditions demand retention of the modifications. To this end, we support Senate Resolution 126, which expresses the sense that the 1981 changes in estate tax laws should not be modified.

ECONOMIC CONDITIONS DEMAND RETENTION OF 1981 LAW

An examination of current economic conditions leads to strong support for those tax law changes. As mentioned above, the effects of inflation on estate values and tax brackets were damaging to small businesses and farms. While substantial gains have been made in the battle against inflation, price increases are expected to continue. The administration's economic projections for major indicators detail a 4.4% rise in the Consumer Price Index for 1984 and a 5.0% Gross National Product Deflater for 1984. The Consumer Price Index figures for April and May of this year were 0.6 and 0.5 respectively, sharp increases although the annual rate is expected to be 4 or 5 percent.

Even at these reduced rates of inflation, the increase in property value and business valuation will still be substantial over a number of years. Importantly, we must remember that the 1981 modifications were designed to offset the great inflation experienced from 1976 to 1980. The peak rate of the GNP deflater was 10.5% in late 1980.

Current economic conditions also increase the degree of business concentration by forcing large numbers of small business closures and sales. Business failures for the first two months of 1982 numbered 4,852, more than three times the number of failures for the same period of 1980 and approximately 1,000 more than in 1981. Business bankruptcy estates filed numbered 47,555 in 1981 and increased to 65,807 in 1982.

Increasing estate and gift taxation at this point in the economic recovery would only serve to aggravate the position of small businesses and farmers that may be on the edge of continuing operation. Without the threat of greatly increased estate taxes, these business owners and managers can concentrate on productive investment and planning rather than tax avoidance schemes. If small business owners spend their time improving their business conditions, that effort will translate into improvement in the economy overall. This is clearly demonstrated by a recent Massachusetts Institute of Technology study that found more than 86% of new jobs were provided by businesses with less than 500 employees.

The negative effect of resource commitment to tax avoidance was a topic of primary concern when this committee discussed reform of estate taxation two years ago, and the subject deserves further review.

ECONOMIC INEFFICIENCY AND DISTORTION CAUSED BY ESTATE AND GIFT TAXATION

It is generally accepted that the national rate of saving which provides capital for investment has been adversely affected by high marginal tax rates and corresponding low after-tax rates of return. The logical reaction of business owners and planners is to avoid taxation by reducing the amount of capital reserved in the company. This reaction to high estate tax rates also contributes to reduced capital expenditures designed to improve or expand the business not only because total saving (or investment) is reduced, but because the need to remain liquid to meet estate tax obligations discourages such investment. Factor in the inefficient expense of time and money to devise alternate tax avoidance plans, and the economic cost adds up to large amounts. A further economic cost to the small business because of excessive estate and gift taxation involves the payment of insurance premiums in order to finance the estate tax due when a company is passed on to family members.

And it is important to remember that this economic cost is incurred to gain Federal revenues that total some 6 to 7 billion dollars, approximately 1% of the Federal government's revenues.

Another concern of this association is the issue of tax equity. As we pointed out in our testimony of June, 1981, the estate tax discriminates against the small business and farm because the tax does not apply to publicly held corporations. The competitive disadvantage is substantial especially when the cost of reduced saving and tax avoidance is considered.

We thank the committee for this opportunity to present our views on this subject.

Senator **Symms**. Thank you both very much.

Senator Bentsen, do you have any questions?

Senator **Bentsen**. No, I have no questions.

Senator **Symms**. Well, I want to thank both of you for being here. I have had the opportunity to work with your organizations, and particularly the ad hoc coalition. I think that those of you in the ad hoc coalition certainly have made a major effort to have your voice heard on behalf of small business and on behalf of farmers and ranchers all over the country, and I really want to compliment you for that.

Senator **Bentsen**. I might comment, if you will allow me, Mr. Chairman. When I look at what has happened to farm income and what has happened to ranch income, we would not increase the exemptions for the transfer of those, to keep them in the family, and then force the sale of them to pay the tax in these kinds of economic conditions that I don't see turning around. You obviously end up with a situation that becomes extremely inequitable and very, very difficult for a family to retain within that family the farm or ranch or a small business.

Senator **Symms**. Thank you very much, Senator Bentsen. I certainly agree with what you are saying.

Now Mr. Swift, you suggested we reduce the rate to 20 percent. I think that is probably one of the most important factors in the entire thing. I mentioned earlier that to have a tax rate of 70 percent on an estate or a so-called death tax to me is outright confiscation, is what it appears like. It is not taxation.

Do you want to elaborate just briefly on what your idea is to reduce the rate to 20 percent?

Mr. **Swift**. Well Senator, it certainly fits and is equitable when compared with the capital gains rates for individuals at the present time. It reduces it from a confiscatory 50 percent, and that coupled with revision of the current use provisions and the time payment provisions would allow a great deal of more orderly planning in the succession of a small business.

Senator **Symms**. It probably could be debated that it might even be that it wouldn't cost the Government too much in revenue loss because it would be so much simpler that many of the big estates might just decide it would be easier to pay it than it would be to try to figure out ways to transfer the ownership and so forth to trusts and what have you. I suppose that argument could be made, couldn't it?

Mr. **Swift**. I would think so, yes.

Senator **Symms**. I have been told that some of the biggest estates in the country have said that if the tax rate was 20 percent, they would just plan on paying it and not worrying about it, instead of trying to set up trusts and other ways to see that the money is sheltered from the tax collectors.

Senator Boren is here, the ranking minority member of the subcommittee. We are glad to have him here this morning.

Senator **Boren**. Thank you very much, Mr. Chairman. I commend you for holding these hearings and as you know, this is a subject that is near and dear to me and I appreciate your giving us the opportunity to have these views aired.

Senator **Symms**. Do you have any questions at the present time?

Senator BOREN. I don't at this time. Thank you.

Senator SYMMS. Thank you very much, gentlemen. We appreciate it and we look forward to working with you.

The next panel consists of James Lockett, president of the Oklahoma Farm Bureau; James Harper, vice chairman, tax committee, National Cattlemen's Association; and Dave Franasiak, manager, Tax Policy Center for the U.S. Chamber of Commerce.

Gentlemen, please come up and be seated. Mr. Lockett of the Farm Bureau, we will take your testimony first.

Senator BOREN. Mr. Chairman, if I could, just before Mr. Lockett begins; I want to express my appreciation to him for being here this morning and my pride in having him here to represent the National Farm Bureau today.

He is an outstanding leader in our State and has been a leader in interest in this particular field of legislation going all the way back to the time that I worked on this as Governor. It was the first bill I had the privilege of signing as Governor, a bill that did away with the State inheritance tax between spouses. The Farm Bureau and Mr. Lockett were very, very active at that time in helping me to pass that piece of legislation. They have been very active in support of the efforts which you and other members of this committee have made to change the Federal estate tax laws and he is certainly a leading spokesman in this whole area from our State and across the country.

So as an Oklahoman, you will forgive me for having some parochial pride in having him here with us this morning.

Senator SYMMS. Well, we are delighted to have you here, Senator Boren and Mr. Lockett, and I appreciate your continued interest in this, along with Senator Bentsen and others on the committee, Senator Wallop. I think we have had a very strong bipartisan posture on this committee in favor of what we have done and I think that generally we would like to do more.

We seem to be getting quite a lot of resistance from Treasury on some of these things right now, which I have to say doesn't seem to be consistent with President Reagan's economic policies, but I think that if we can at least preserve what we have gotten done, that is a big step, and then I think we have these other steps that really do need to be taken. I know that if we push at it, we are going to get some of this accomplished. At least that is certainly my goal.

I trust that you got that roping a calf down in Oklahoma or something?

Mr. LOCKETT. I got bucked off my horse and broke my arm. I am a good rancher but a poor cowboy.

Senator SYMMS. Maybe it is a good horse.

Mr. LOCKETT. The American Farm Bureau Federation just voted to give the horse the distinguished service award this year for slowing me down.

Senator SYMMS. Go right ahead.

STATEMENT OF JAMES LOCKETT, PRESIDENT, OKLAHOMA FARM BUREAU, ON BEHALF OF AMERICAN FARM BUREAU FEDERATION

Mr. LOCKETT. Thank you, Senator Boren and Mr. Chairman. I am James Lockett. I own and operate a cow-calf ranch in Osage County, Okla. I am here today representing the American Farm Bureau Federation.

You have a complete written testimony of mine submitted for the record. If you allow, I will just very briefly summarize it.

Senator SYMMS. All of the prepared statements will be part of the record today, so please go right ahead.

Mr. LOCKETT. Thank you, sir. Repeal of the Federal estate tax is an important goal of Farm Bureau, and we will work toward the accomplishment of this goal through the endorsement of Senate bill 1250. It is true that repeal would mean a revenue loss, but it is also true that there are many opportunities to reduce Federal spending to offset this relatively small tax revenue loss. The budget should be balanced by spending cuts rather than increasing taxes.

The estate tax is a disincentive to savings, investment, and productivity. It is inconsistent with the emphasis on capital formation and the desire of many taxpayers to pass the results of their hard work on to their children and grandchildren.

Farm Bureau is opposed to the proposed tax freeze that would freeze current estate tax credits and rates at the 1983 levels. Rather than allowing them to escalate as mandated in the Economic Recovery Tax Act of 1983, the proposed estate tax freeze is actually a tax increase.

Farm Bureau supports Senate Resolution 126 introduced by Senator Wallop to express the sense of the Senate that the estate tax changes included in ERTA should not be modified.

And again, Mr. Chairman, I want to thank you for the opportunity to appear here and speak to the committee.

[The statement of Mr. Lockett follows:]

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION BEFORE THE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION OF THE SENATE COMMITTEE ON FINANCE WITH REGARD TO ESTATE AND GIFT TAX LAWS

Presented by
James L. Lockett, President of the Oklahoma Farm Bureau

June 27, 1983

The American Farm Bureau Federation appreciates the opportunity to testify on estate and gift tax laws as well as legislation designed to repeal or modify current statutes. Farm Bureau has appeared before the Senate Finance Committee and its Subcommittees on many occasions to discuss our position on estate taxes.

Farm Bureau has had a longtime interest and involvement in the federal estate and gift tax area because of its effect upon the well-being of the nation's farm and ranch families. Farm Bureau actively supported estate tax relief in the Tax Reform Act of 1976, the Revenue Act of 1978, the repeal of the carryover basis, and the Economic Recovery Tax Act of 1981 (ERTA). The continuing interest of our three million member families is reflected in the following policy which was adopted by the voting delegates of the member State Farm Bureaus at the American Farm Bureau Federation's annual meeting in January, 1983:

Federal Estate Taxes

> "We favor repeal of the federal estate tax and until this is accomplished, we will continue to support legislation to reduce the impact of the federal estate tax on the orderly transfer of property and to exempt property on which an estate tax has been paid within 15 years prior to the death of the second decedent."

Repeal of the federal estate tax is a long-term goal of Farm Bureau. Estate tax reform in 1976 and 1978 debatably eased the economic and administrative burdens associated with the estate tax. However, such reform provided no permanent remedy for the increasingly heavy taxation of farm estates whose major asset--land--had been highly inflated. A result of inflation was to subject many small and moderate-size estates to the estate tax. The $47,000 unified credit enacted in 1976 had become of little benefit to most farm and ranch estates. Special use valuation, which had been hailed as an answer to estate tax problems for agriculture, had become so entangled in the regulatory decisions of the Internal Revenue Service that the executors and heirs of some estates decided to forego its application entirely. Material participation requirements and valuation procedures were restrictive to the point of negating a law intended to benefit farms and other small businesses.

Fortunately, Congress responded to the call of America's farmers and ranchers in 1981 by enacting far-reaching changes in estate and gift tax law. The Economic Recovery Tax Act of 1981 not only increased the estate tax credit, but reduced the estate tax rates and made important modifications in Section 2032A, special use valuation. The increase in the credit will eventually exempt estates valued up to $600,000 from the estate tax. This particular provision is considered a lifesaver for the heirs of many farmers and ranchers who otherwise could be faced with the task of selling part of the estate to pay the taxes on it.

Against this background of favorable changes in estate laws, farmers and ranchers in 1983 are now threatened with the prospect of restrictions in the recently liberalized tax treatment of their estates. The conference agreement on the First Concurrent Budget Resolution, H.Con.Res. 91, calls for new tax revenues of $12 billion in FY 1984, $15 billion in 1985, and $46 billion in 1986. Farmers can be certain that estate tax law is on the firing line as a potential source of revenue.

In February, 1983, the Congressional Budget Office (CBO) listed a freeze in current estate and gift tax law as a revenue raising option for Congress to consider during FY 1984 budget deliberations. In its report, the CBO noted:

> "Further expansion of the estate tax credit can be criticized on several grounds. According to 1979 data, only about 3.5 percent of those dying in 1979 at age 45 and over had estates valued at more than $250,000. Any extension of the credit thus applies to only a small percentage of very wealthy taxpayers."
>
> --Congressional Budget Office report on strategies for reducing the federal deficit. (February 10, 1983, p. 314.)

The CBO or anyone who thinks that the scheduled expansion of the estate tax credit applies only to wealthy taxpayers has not spoken with any farmers recently about this subject. While the CBO states that estates of more than $250,000 belong to "very wealthy taxpayers," that assertion probably would be news to the farmer or rancher. A farmer whose land is worth $1,000 an acre would only need 250 acres to have an estate that large--the average U.S. farm IS slightly over 400 acres. Inflation has pushed the dollar value of property up and has forced many estates into higher estate tax brackets. As a result, the federal government receives a larger portion of an estate in taxes. We need a unified credit equivalent to an effective exemption of $353,500 in today's dollars to just equal the $60,000 estate tax exemption of 1942. The average farm owner's equity in 1982 was $368,000.

The proposal to freeze the phased expansion of the estate tax credits is part of a tax freeze package proposed by Rep. Dan Rostenkowski, Chairman of the House Ways and Means Committee. This is an effort to use tax increases, rather than spending reductions, to lower the deficit. If enacted, the Rostenkowski proposal would freeze the current estate exemption at the 1983 level of $275,000 and the tax rate at 60 percent, rather than allowing the exemption to increase to $600,000 by 1987 and the rate to drop to 50 percent by 1985.

Farm Bureau opposes the freeze proposal. A freeze is in fact a tax increase and is an "invisible" way for Congress to repeal the ERTA provisions. This is ironic when one considers that during the tax debate of 1981, the House and Senate engaged in rather obvious competition to see which house could provide the biggest breaks in the estate tax laws. Farm Bureau supports the retention of the 1981 estate tax modifications. Farmers relied upon congressional decisions in 1981 for the development of their personal estate plans. To freeze current law would wreak havoc with these plans. Farmers incur considerable costs in establishing estate plans. Each change in the law adds to these costs.

The freeze proposal is not a particularly effective way to raise revenues when estate taxes constituted only 1.3 percent of federal revenues in 1982. A freeze in the unified estate and gift tax credit at the 1983 level would produce approximately $6 billion between FY 1984 and FY 1988, while the freeze in rates at the 1983 level of 60 percent would produce increased revenues of $1.7 billion between FY 1984 and FY 1988. While this amount may seem small in the context of the total revenue picture, it is significant and at times devastating to individual farm heirs who must pay the tax.

The estate tax is a disincentive to savings, investment, and productivity. It is a tool of those who adhere to the philosophy of using tax policy to accomplish social goals, i.e., the redistribution of wealth. The size of farming operations often increases in order to maintain a semblance of profitability in agriculture. Farmers cannot pass their costs to consumers through increased commodity prices. Often, their only alternative is to increase their production base. Excessive estate tax levies can force the sale and splintering of this production base into units too small to efficiently or profitably produce food and fiber.

To penalize heirs for efforts of their decedents to establish profitable businesses is fundamentally wrong in America's capitalistic private enterprise system. That notion is inconsistent with the emphasis on capital formation and the desire of many hard-working taxpayers to pass the fruits of their labor to their children and grandchildren.

In April, the American Farm Bureau Federation launched a major organizational campaign encouraging Farm Bureau members to communicate to members of Congress their opposition to any tax increases that may be required by the First Concurrent Budget Resolution. Farm Bureau's tax campaign has focused on three major points: 1) Support full retention of the third year individual tax rate cut and oppose a cap; 2) Support currently scheduled increases in the estate tax credit and rate reduction; and 3) Support tax indexing scheduled to begin in 1985. We believe that this broad based farmer input will help convince Congress to maintain current tax laws.

In the long-term, Farm Bureau supports repeal of the estate tax. We will work toward the accomplishment of this goal through the endorsement of bill S. 1250, introduced by Senator Symms, to repeal federal estate and gift taxes. We commend Senator Wallop's introduction of S.Res. 126 and co-sponsorship by Senators Symms, Grassley, and Boren to express the sense of the Senate that the estate tax changes made in the Economic Recovery Tax Act of 1981 should not be modified. Farm Bureau policy also addresses provisions contained in other legislation pending before the Subcommittee. While none of these bills provides for elimination of the federal estate tax, they do allow a greater measure of estate tax relief for farm families. We commend the sponsors of these bills and offer our support for them as steps in phasing out the estate tax.

We thank the Subcommittee for its consideration of estate and gift tax laws. Again, Farm Bureau reemphasizes its commitment to repeal. As Farm Bureau stated during Subcommittee hearings in 1981, estate tax reform is the management of the problem; repeal is the solution.

APPENDIX

While an estate tax freeze would raise insignificant revenues compared to total federal revenues, the impact on individual family farms and businesses can be substantial.

This table shows the effect of a freeze on taxable estates of $500,000 and $750,000.

EXAMPLES OF CURRENT LAW VS. A FREEZE ON ESTATE TAXES

$500,000 Taxable Estate

	1983	1984	1985	1986	1987
Gross Tax	$155,800	$155,800	$155,800	$155,800	$155,800
Less Credit	79,300	96,300	121,800	155,800	192,800
NET TAX (current law)	$ 76,500	$ 59,500	$ 34,000	-0-	-0-
NET TAX (freeze)	$ 76,500	$ 76,500	$ 76,500	$ 76,500	$ 76,500
Additional Tax Due to Freeze	-0-	$ 17,000	$ 42,500	$ 76,500	$ 76,500

$750,000 Taxable Estate

	1983	1984	1985	1986	1987
Gross Tax	$248,300	$248,300	$248,300	$248,300	$248,300
Less Credit	79,300	96,300	121,800	155,800	192,800
NET TAX (current law)	$169,000	$152,000	$126,500	$ 92,500	$ 55,500
NET TAX (freeze)	$169,000	$169,000	$169,000	$169,000	$169,000
Additional Tax Due to Freeze	-0-	$ 17,000	$ 42,500	$ 76,500	$113,500

Senator Symms. Thank you very much. I think it might be worthy just to note that on your table that you put on the back, where you have a $750,000 taxable estate, that the difference in the tax, if I am reading it correctly, in the $750,000 estate, and incidentally for a land poor farmer, it is not necessarily that high. Somebody can have that kind of an estate and actually be pretty hard up financially just because of the cash flow problems.

You are talking about $113,000 difference.

Mr. Lockett. In the tax.

Senator Symms. And I think Senator Bentsen touched on what the problem is. The way farm prices are, to have to pay $113,000 tax on a $750,000 farm would just about be the end of the business.

Mr. Lockett. Your historic rate of return on farms and ranches is something 4 percent or less.

Senator Bentsen. Or pay the interest charge on installment payment of the tax. And I dare say you would not be receiving that kind of return from the ranch.

Mr. Lockett. There is an old saying that farmers live poor and they die rich, and that saying stems from the estate tax. That is where it originated.

Senator Boren. The average home on our 88,000 farm ranch units in Oklahoma last year had a per capita income of $14. Now that was the average per capita, so you can see that you would have a dickens of a time paying $169,000 in taxes with that rate of return.

I would just like to ask Mr. Lockett, how often do you find the circumstance in which the death of the head of the family causes—forces—the rest of the family to sell the farm or ranch in order to pay the inheritance tax? I wonder if that often doesn't merely create larger units because very often the purchaser is the larger unit. The inheritance tax, in the beginning, was created to prevent large concentrations of wealth. Would you gree with me that what you usually see is the opposite of that now, that is, the smaller units that have to sell off to pay the tax are acquired by the larger units.

Mr. Lockett. That is very true, Senator. I have some friends who did have to dispose of ranches in the county over the years because of taxes. Estate tax was paid on our family ranch in 1941 at the untimely death of our patriarch and the tax at that time was not onerous at all. In fact, it was hardly noticeable. At that time, there were three potential heirs and they received the property.

The family has grown to the point now that the next death, which we hope is years down the road—our matriach is 87 now—there is a potential 27 heirs. This in itself will break up the estate. If it is a social goal that the Government is after by putting oppressive estate taxes on, sometimes, like you say, that works to the opposite.

If it has to be sold for taxes, it will go into one major purchaser probably, if at all possible. If it stays in the family, eventually the ownership is going to be split 27 ways on 7,000 acres. So it can work both ways.

Senator Symms. Thank you. Mr. Harper.

STATEMENT OF JAMES HARPER, VICE CHAIRMAN, TAX COMMITTEE, NATIONAL CATTLEMEN'S ASSOCIATION, ACCOMPANIED BY ALVIN J. GESKE, ESQ., DAVIS & McLEOD, WASHINGTON, D.C.; J. BURTON ELLER, JR., VICE PRESIDENT, GOVERNMENT AFFAIRS, NATIONAL CATTLEMEN'S ASSOCIATION, DENVER, COLO.

Mr. HARPER. Thank you, Mr. Chairman, members of the committee.

I am Jim Harper, a cattle rancher from Ashland, Kans., appearing as vice chairman of the tax committee of the National Cattlemen's Association. I am accompanied by Burton Eller, NCA's vice president of government affairs, and Alvin J. Geske of Davis & McLeod.

The National Cattlemen's Association commends Senators Symms, Boren, and Bentsen for their continuing interest in reducing the estate tax burdens of farmers, ranchers, and other small businessmen and their interest in solving administrative problems created by the estate tax laws.

The estate laws place a unique burden on farmers, ranchers, and small businessmen. To be an economically viable unit, a family farm or ranch must often include from three-quarters of a million to several million dollars of illiquid assets. It is often not feasible to sell off a portion of the ranch to pay estate taxes because a sale of a part of the ranch would leave a unit which is too small to be economically viable. Borrowing to pay estate taxes is often not feasible because of the other credit needs of the business or the cost of servicing the debt. Also, because of the needs of most ranches for additional capital and the low rate of return on ranch assets, many ranchers cannot afford to provide a fund for estate tax liabilities through insurance or otherwise.

NCA believes that the phase-in of the maximum rate of tax and of the unified credit were not designed to adjust for future inflation. The primary justification for the decrease in the maximum rate of tax was that a 70-percent rate was too high, just as a 70-percent maximum income tax rate was considered too high. The increase in the unified credit to $600,000 was justified because the 1976 changes were inadequate to compensate for 40 years of inflation and for the fact that many small businesses have become much more capital-intensive.

Another reason to oppose changes in the provisions added in 1981 is the need for continuity. Many farmers, ranchers, and small businessmen have altered their estate plans in reliance on the 1981 provisions. To require them to revise their estate plans again within 2 years would be costly and would further the cynical attitude which many businessmen have developed after nearly a decade of almost continuous major revisions to the tax code.

For these reasons, NCA believes that the estate tax laws should be further liberalized and that the estate tax changes made in the 1981 Tax Act should not be cut back. Accordingly, in agreement with the Treasury Department, NCA strongly supports Senate Resolution 126, which would express the sense of the Senate that the scheduled phasein of increases in the unified credit and decreases in the maximum rate of tax should be retained.

NCA supports repeal of the estate and gift taxes or substantial reductions in the impact of such taxes while recognizing that revenue considerations may not make this a course of action which could be fully accomplished immediately.

NCA also believes that the tax on generation-skipping transfers should be repealed or substantially modified. NCA would be willing to study the Treasury proposal for modifications of this tax, but favors repeal unless adequate assurances can be given that the proposal adequately addresses the concerns of complexity and unintended consequences that plague the existing tax on generation-skipping transfers.

NCA commends the IRS for beginning to interpret some aspects of the rules relating to extended payment of estate taxes in a more liberal manner. However, NCA supports further liberalization of these rules along the lines proposed in S. 1251.

In particular, NCA urges enactment of the provisions of S. 1251 which would (1) Permit assets owned directly or indirectly by a decedent to qualify for deferred payment of estate taxes where such assets are leased to or used by a family-owned business; (2) provide a judicial forum for settling disputes with the IRS over eligibility under section 6166; and (3) modify the rules concerning the amount of interest imposed on deferred estate tax payments and the manner in which such interest can be claimed as an estate tax deduction.

NCA also supports enactment of provisions which would permit judicial review of disputes arising under the rules relating to special valuation of farm and ranch property, even if the disputes do not result in a current tax deficiency.

Thank you for your time and we will be happy to try to answer any questions.

[The statement of Mr. Harper follows:]

STATEMENT

of the

NATIONAL CATTLEMEN'S ASSOCIATION

to the

Subcommittee on Estate and Gift Taxation

Committee on Finance
United States Senate

Relative to Estate Tax Issues

Presented by
James Harper
Vice Chairman, Tax Committee
National Cattlemen's Association

accompanied by

J. Burton Eller, Jr.
Vice President, Government Affairs

and

Alvin J. Geske
Davis & McLeod

June 27, 1983

STATEMENT

I. Introduction

Estate and gift taxes often place a unique burden on farmers, ranchers, and many other small businessmen. To be an economically viable unit, a family farm or ranch will often have to include from three-quarters of a million to several million dollars of illiquid assets, and it is often not feasible or practical to sell off a portion of the farm or ranch to pay estate taxes because doing so would leave a unit which is too small to be economically viable. Also, because of the low rate of return on farm and ranch assets, many farmers and ranchers cannot afford to provide a fund for estate tax liabilities through insurance or otherwise. Consequently, National Cattlemen's Association (NCA) and other agricultural organizations have long been concerned about the impact of estate tax laws on the owners of family farms, ranches, and other closely held businesses.

Due in large part to the continuing concern of Senator Symms and a number of other Members of the Committee on Finance, significant improvements have been made in the estate and gift tax rules in recent years, although there are still substantial improvements which could be made. NCA appreciates Senator Symms' continuing concern and the opportunity to testify today on various proposals which would eliminate estate and gift taxes altogether, improve the existing rules, and prevent reduction in the hard-won benefits which were achieved in 1981.

II. Estate and Gift Tax Freeze

The Economic Recovery Tax Act of 1981 (the 1981 Tax Act) made a number of improvements to the estate and gift tax rules, including increasing the unified credit, decreasing the maximum rate of tax, providing for an unlimited marital deduction, and improving the provisions relating to special valuation of certain real property. Prior to the 1981 Tax Act, the unified credit for estate and gift taxes was generally the equivalent of an exemption of $175,625, and the maximum rate of these taxes was 70 percent. The 1981 Tax Act increased the exemption equivalency of the unified credit and reduced the maximum rate as follows:

Year	Exemption Equivalent	Maximum Rate
1982	$225,000	65%
1983	$275,000	60%
1984	$325,000	55%
1985	$400,000	50%
1986	$500,000	
1987	$600,000	

A part of Congressman Rostenkowski's proposal to eliminate all tax reductions scheduled to become effective after 1983 is freezing the exemption equivalent of the unified credit at $275,000 and the maximum rate at 60 percent.

In response to this proposal, Senator Wallop, with co-sponsorship of Senators Boren, Symms, Durenberger, Grassley, Bentsen, Dole, Roth, Baucus, and others introduced S. Res. 126, which would express the sense of the Senate that changes in the federal estate tax laws which were made by the 1981 Tax Act are vital to the continuation of family farms and small businesses, and such changes should not be repealed or amended, but rather should be allowed to run their course. A similar House resolution, H. Res. 216, was recently introduced with a total of 66 co-sponsors.

NCA strongly supports S. Res. 126 and commends all of its sponsors. As noted above, estate and gift taxes place a unique burden on farmers, ranchers and certain small businessmen because such businesses will often have to include from $750,000 to $2,000,000 of illiquid assets. A partial disposition of the property to pay estate taxes is often not feasible because doing so would leave a unit which is too small to be economically viable. Furthermore, because of the low rate of return on farm and ranch assets, most farmers and ranchers could not afford to provide a fund for estate tax liabilities through insurance or otherwise.

In addition, the existence of estate taxes with high rates and applicability to substantial numbers of businesses encourages individuals to structure their affairs in manners which are motivated by tax minimization, not by attempts to find the most profitable use of their assets. This structuring is inappropriate from a tax policy standpoint. All individuals should be encouraged to utilize their assets to maximize the rate of return, not to avoid estate taxes.

NCA believes that the phase-in of the maximum rate of tax and of the unified credit were not designed to adjust for anticipated future inflation. The primary justification for the decrease in the maximum rate of tax was that a 70 percent rate is too high, just as a 70 percent maximum income tax rate was considered too high. Consequently, both maximum rates were reduced to 50 percent by the 1981 Tax Act. Similarly, although some may argue that future increases in the unified credit are not needed because the rate of inflation has dramatically decreased, this argument overlooks the principal reasons for increases in the unified credit. First, increases in the unified credit were not intended to compensate for inflation as can be seen by the fact that the increase far outpaces any reasonable 1981 estimate of what inflation might have been. Rather, the phase-in was done because of revenue concerns in the early years, and the $600,000 figure was deemed to be an appropriate exemption level. Second, one of the principal reasons for the increase in the credit was that estate tax exemption had remained at $60,000 from 1942 to 1976 (and the gift tax exemption remained at $30,000 for many years prior to 1976) even though inflation had effectively cut the value of the exemptions by two-thirds. Thus, the 1976 changes in the exemption level which were phased-in over five years were not even sufficient to adjust for the 1942-1976 inflation and did not take into account, or anticipate, the substantial inflation from 1976 through 1981. Furthermore, the increases in the exemption level in 1976 failed to adjust adequately for the fact that many types of small businesses, including family farms and ranches, had become much more capital intensive since 1942. The 1981 changes, when fully phased in, were intended to address this concern.

Another reason to oppose changes in the provisions added in 1981 is the need for continuity. Many farmers, ranchers and small businessmen have altered their estate plans in reliance on the new provisions. To require them to revise their estate plans again within two years would be costly and would further the cynical attitude which many businessmen have developed after nearly a decade of almost continuous major revisions of the Tax Code.

III. Repeal of Estate and Gift Taxes

One of the bills to be discussed at this hearing is S. 1250, introduced by Senator Symms and co-sponsored by Senators Jepsen, Helms, McClure and Boren. This bill would repeal the estate and gift taxes and the tax on generation-skipping transfers.

For the same reasons that NCA opposes a freeze of the 1981 estate tax changes, NCA has long supported repeal of the estate and gift taxes. These taxes pose special hardships on family farms, ranches and many small businesses. Also, these taxes influence many people to plan their affairs to minimize estate taxes, rather than to invest their time and assets in the most profitable way.

NCA recognizes that, given the large projected budget deficits for the next few years, it may be inappropriate at this time to repeal the estate and gift taxes. However, NCA's long-term objective is the repeal of these taxes, and we commend Senator Symms for his continuing advocacy of this position.

NCA would also support, hopefully as an interim step to repeal, reduction of the impact of the estate and gift taxes through a balanced approach of the sort proposed by the Ad Hoc

Committee on Estate Taxation, which combines substantial rate reductions, increases in the unified credit, and liberalization of the rules relating to special valuation of closely held businesses and assets used in such businesses.

IV. Repeal of the Tax on Generation-Skipping Transfers

NCA also supports efforts to repeal, or very substantially modify, the tax on generation-skipping transfers. This tax, which was originally enacted as part of the Tax Reform Act of 1976, was intended to prevent extremely wealthy individuals from having their fortunes taxed only once every second generation, rather than once each generation. While the aim may have been to create equity, in practice, the tax has primarily created confusion. It is generally agreed that, in its present form, the tax is completely unworkable and presents many potential obstacles even for transfers of limited dollar amounts if the transfers have the potential to skip a generation.

Senator Symms, with the co-sponsorship of Senators Armstrong, Boren, Grassley, Wallop, Pryor and others, has introduced S. 1252. a bill which would repeal the tax on generation-skipping transfers. Also, the Treasury Department has recently proposed a program which would very substantially modify the tax on generation-skipping transfers. Some of the key elements to this new approach are (a) a very substantially increased exemption level, (b) applicability of the tax to certain direct transfers (as opposed to only transfers in which the intervening generation has an interest or a power) and (c) apparently substantial simplification.

NCA strongly concurs that the tax on generation-skipping transfers should be repealed or substantially modified. Although we have not had a chance to examine the Treasury proposal in detail, it would probably be substantially more palatable than existing law. However, unless NCA can be assured that the proposal would not impose any significant obstacles to the transfer of assets of family farms and ranches or small businesses, we would continue to support repeal.

V. Installment Payment of Estate Taxes

One of the ways that Congress has addressed the concerns of farmers, ranchers and small businessmen about the impact of estate taxes on illiquid estates is through Section 6166 of the Code. This section generally permits an estate to defer a portion of the estate taxes attributable to certain closely held businesses and to pay off these taxes over a period of up to 15 years.

From time to time, technical problems resulting from unanticipated factual situations or overly restrictive IRS interpretations have resulted in the benefits of this 15-year deferral provision not being available to family farms and ranches. As a result, Congress has reexamined this provision and made changes to insure that estate tax deferral is available for use by the types of taxpayers whom they intended to benefit. Thus, improvements in this provision were made in the Tax Reform Act of 1976 and again in the 1981 Tax Act.

Notwithstanding the significant improvements which have been made to this extended payment provision, there are still a number of additional changes which would substantially improve it.

NCA commends Senator Symms for his continuing interest in improving the administration of the estate tax laws. S. 1251 is another step in that direction. NCA also compliments Senators Wallop, Boren, Grassley and Bentsen for sponsoring this important bill. NCA supports the basic goal of making the extended payment provision more workable and administrable.

Under the extended payment provisions, deferral is available only with respect to the tax attributable to qualifying closely held business interests. A qualifying business interest must be either a trade or business carried on by the decedent as a proprietor or an interest in a partnership or corporation which is engaged in carrying on a trade or business at the time of the decedent's death. If a business has been carried on by a decedent as a sole proprietor, the closely held business includes only the assets of the decedent which are actually utilized by him in the trade or business.

In a series of rulings, the IRS has set forth guidelines for determining what constitutes a trade or business for purposes of Section 6166. These guidelines set up a somewhat narrower definition of a trade or business than applies in other areas of the tax law. In general, these rulings do not treat the management of income-producing property as a trade or business. Consequently, the splitting of a owner's business by transferring some assets to a family corporation but retaining individual ownership of the farm real property which is leased to the corporation may prevent his estate from using installment payments for estate tax purposes. In one situation, a decedent incorporated a sole proprietorship but retained personal ownership of the land and buildings used in the business. The decedent leased the real property to the corporation which used it in the corporation's business. The IRS ruled that the decedent's ownership of the real property did not qualify as a business and, therefore, could not be taken into account in determining whether the estate met the percentage requirements for deferral of estate tax.

Recently, the IRS has issued private rulings incorporating a more liberal interpretation of the "trade or business" requirement where the decedent or the decedent's agent performed substantial personal services in managing, maintaining and leasing the property. In a farm or ranch context, this generally means that a decedent's estate may satisfy the "trade or business" test if there is material participation under a crop-share lease of the property. NCA commends the IRS for adopting a more workable approach to the issue of when real property is a part of a closely held business and urges the IRS to use these private rulings as a basis for published revenue rulings so other taxpayers can rely on these rulings.

However, there are still improvements which should be made in the IRS approach to what property is included as part of a closely held business. Thus, the IRS position appears to be that a cash lease of farm or ranch property by a decedent to a family corporation or partnership will not meet the "trade or business" requirement. Yet, it is a common occurrence for farmers or ranchers to cash lease agricultural property to a family owned business. To deny the benefits of deferred payment of estate tax to the estates of these farmers or ranchers seems inequitable.

Similarly, giving up active participation in farming or ranching because of age and health may result in the loss of the use of the extended payment provisions. In one situation, a 96-year-old farmer gave his children the livestock used on his farm and leased the farm property to them on a rent-free basis. The farmer, who took no further interest in the management of the farm, died a year later. The IRS ruled that neither the livestock, which was included in his estate because the gift was made within three years of his death, nor his real property qualified as an interest in a closely held business because he had not actively participated in carrying on the farm business. Thus, as interpreted by the IRS, the present provisions are not adequate to allow estate tax deferral in many situations where the family is carrying on a trade or business on property even though the decedent is not personally doing so.

S. 1251 solves these problems caused by IRS interpretation of what is a "trade or business." The bill provides that extended payment of estate taxes would apply to assets used by a closely held business whether such assets are directly owned by the business or leased to the business by a partner or shareholder. Thus, assets that were directly or indirectly owned by the decedent and leased to a family owned business would qualify for deferred payment of estate tax if such assets were used in the business for a period of one year prior to the decedent's death and if the decedent's interest in the business met the requirements of Section 6166. As it has in the past, NCA strongly urges passage of this important and needed provision.

There are many circumstances under which it may not be clear as to whether an estate is eligible to elect to defer estate taxes under Section 6166. Because of the language of the jurisdictional provisions of the Code, it appears that there is no practical way to contest in court a decision by the IRS to deny an executor's election to defer estate taxes under Section 6166.

NCA believes that estates should be able to obtain judicial review of disputes with the IRS arising under Section 6166. S. 1251 would provide a judicial forum for reviewing questions raised by IRS regarding whether estates qualify for the right to defer payment of estate taxes. For the same reasons, NCA believes that disputes arising under Section 2032A, which allows the special use valuation of farm and ranch property, should be subject to judicial review even if the disputes do not result in a current tax deficiency.

Under present law, a four percent interest rate is available with respect to the estate tax liability on the first $1 million of the taxpayer's gross estate which is deferred under the extended payment provision of Section 6166. All other interest on amounts of estate tax deferred under Section 6166 bears interest at the same rate that underpayments of taxes generally bear. By reason of changes made in the 1981 and 1982 Tax Acts, the rate of interest on underpayments of tax is to be 100 percent of the prime rate, is to be adjusted semi-annually, and is to be compounded daily. Under the new rules, the rate of interest was to 20 percent from February 1, 1982, to December 31, 1982; has been 16 percent from January 1, 1983, to the present; and will be 11 percent beginning on July 1, 1983. As a consequence, the availability of Section 6166 to estates of farmers, ranchers and other closely held businesses has been seriously impeded since many of these estates cannot afford to pay these high rates of interest.

Most commercially viable family cattle operations are extremely capital intensive--requiring substantial capital investment in land, livestock, buildings and equipment. In many areas of the country, a commercially viable ranch necessarily will exceed $1 million. Consequently, many farm and ranch estates will exceed $1 million even though the owners are not thought of as wealthy, and these estates will be able to defer payment of estate taxes only by paying very high interest rates on a portion of the tax deferred. The assets used in cattle and other agricultural operations normally cannot generate the type of cash return necessary to service an estate tax debt bearing interest rates ranging from 11 to 20 percent, particularly when most ranches are also servicing high-interest operating loans. As a result, the allowance of a deferred payment provision with high interest rates will not provide any meaningful benefit to many estates containing cattle or other farm operations. In order to provide for a deferred payment provision with utility to cattle and other agricultural operations, the interest rates should have a cap or some other limitation which would be significantly below the prime rate.

Besides retaining the current four percent rate and providing a reasonable interest rate on the amount of deferred tax exceeding that qualifying for the four percent rate, attention needs to be given to the administrative and compliance difficulties created under present law when the interest on the deferred tax is claimed as an estate tax deduction with the result that an amended estate tax return has to be prepared and filed each year during the deferral period. This is burdensome and costly both to estates and to the IRS.

While perhaps not perfect, S. 1251 contains provisions which would address these problems. Under S. 1251, the four percent interest rate would be retained and the interest rate on the excess estate tax would be geared to the then prevailing yield on Treasury obligations of comparable maturity. All interest attributable to the deferred payment of estate tax would be deducted when the estate tax return was filed. This would eliminate the need to recompute the estate tax and file an amended estate tax return for each year of the payout period. Thus, S. 1251 would preserve the current rules on deductibility of interest on the deferred tax and would greatly simplify current procedures. NCA endorses this provision of S. 1251 and would urge it passage.

VI. Conclusion

We compliment Senator Symms for his continuing interest in estate and gift taxes and greatly appreciate the opportunity to testify at this hearing.

Because of the severe impact which estate taxes can have on family farms and ranches, NCA supports:

(1) retention of the phase-ins of the unified credit and estate tax rate reductions provided in the 1981 Tax Act;

(2) ultimate repeal of the estate and gift taxes, or, if this is not possible, substantial further reductions in these taxes;

(3) repeal, or very substantial modification, of the tax on generation-skipping transfers; and

(4) substantial liberalization of the rules allowing extended payment of estate taxes along the lines of S. 1251, particularly those provisions which would:

  (a) permit assets owned directly or indirectly by a decedent to qualify for deferred payment of estate tax where such assets are leased to or used by a family owned business;

  (b) provide a judicial forum for determining eligibility under Section 6166; and

  (c) modify the rules concerning the amount of interest which can be imposed on deferred estate tax payments and the manner in which such interest can be claimed as an estate tax deduction.

Senator **Symms**. Thank you very much, gentlemen. We appreciate your support and your continued interest in this very important question.

David Franasiak.

STATEMENT OF DAVID E. FRANASIAK, MANAGER, TAX POLICY CENTER, U.S. CHAMBER OF COMMERCE

Mr. **Franasiak**. My name is David Franasiak, manager of the Tax Policy Center of the U.S. Chamber of Commerce.

Estate taxation is of particular interest to our small business members. Fifty-four percent of the chamber's members have less than 10 employees, while 87 percent have less than 50 employees.

The chamber strongly supports the preservation of the estate and gift tax reforms inaugurated by the Economic Recovery Tax Act of 1981. It strengthened the family by eliminating provisions of the tax law which virtually forced the sale of family farms and businesses at distressed prices in order to pay estate and gift taxes.

ERTA's estate tax provisions represent an important step toward abolishing the discriminatory tax rates on income derived from capital. The new law eliminated the widow's tax by the creation of an unlimited marital deduction. Last, by increasing the annual exclusion to $10,000, ERTA eliminated undesirable Federal taxation of small gifts.

The chamber also supports efforts to simplify the tax code and the regulations thereunder. Although we do not have specific comments regarding the Treasury Department's attempt to work out a more intelligible and workable generation-skipping tax, we applaud in principle their efforts and we are grateful for Senator Symms' efforts in this area.

I might also say that we are appreciative of the support of Senators Bentsen and Boren in their cosponsoring Senate Resolution 126.

More generally, the administration of and compliance with our increasingly complex and ponderous Tax Code is a substantial impediment to continued economic growth. Instead of producing goods and services, businessmen spend a great deal of their time and money either considering the tax implications of a transaction or complying with the morass of tax regulations.

The chamber opposes efforts to roll back the needed relief provided by ERTA. Specifically, we oppose any efforts to freeze either the progressive increase in the credit amount or the steady decrease in the top marginal estate tax brackets. The adverse effects of these tax increases would far outweigh any benefit resulting from the increased Federal revenue.

As this committee knows, estate tax reform is and will continue to be one of the most important concerns of the small business community. It was one of the recommendations of the 1980 White House Conference on Small Business, and we applaud the work of this committee in this area on behalf of small business.

I can assure this committee that the estate tax reforms contained in the 1981 Tax Act will not be easily relinquished by our small business members. Thank you very much.

[The statement of Mr. Franasiak follows:]

STATEMENT
on
ESTATE TAXATION
before the
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
of the
SENATE FINANCE COMMITTEE
by the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
David E. Franasiak
June 27, 1983

My name is David E. Franasiak, Manager of the Tax Policy Center of the Chamber of Commerce of the United States.

Estate taxation is of particular interest to our small business members. Fifty-four percent of the Chamber's members have less than 10 employees, while 87 percent have less than 50 employees.

SUMMARY

The Chamber strongly supports preservation of the estate and gift tax reforms inaugurated by the Economic Recovery Tax Act of 1981 (ERTA). It strengthened the family by eliminating provisions of the tax law which would have virtually forced the sale of family farms and businesses at distress prices to pay estate and gift taxes. The new law eliminated the "widow's tax" by the creation of an unlimited marital deduction. Lastly, by increasing the annual exclusion to $10,000, ERTA eliminated undesirable federal taxation of small gifts.

The Chamber also supports efforts to simplify the tax code and regulations thereunder. Although we do not have specific comments regarding the Treasury Department's attempt to work out a more intelligible and workable "generation skipping" tax, we applaud, in principle, their efforts and Senator Symm's efforts, in this area.

The Chamber opposes efforts to roll back the needed relief provided by ERTA. Specifically, we oppose any efforts to freeze either the progressive increase in the unified credit amount or the steady decrease in top marginal estate tax brackets. The adverse effects of these tax increases would far outweigh any benefit resulting from the increased federal revenue.

The Value of Testamentary Disposition

The right to transfer property by will has the positive values of fostering and rewarding industry, ingenuity, thrift and productivity, promoting capital formation through savings and investment, permitting continuity in ongoing enterprises, encouraging private philanthropy and strengthening the family as the basic economic unit. Moreover, the right of testamentary disposition often has the effect of preventing concentrations of economic power while, on the other hand, a large tax on that right creates greater concentration.

The American economic system is based on the premises that individuals have a right to dispose of their property as they see fit and that, on the whole, an economic system based on that right will be more productive and efficient than a system based on public control of resources. This faith in the efficacy of private discretion and decision making should extend to decisions by individuals regarding the proper disposition of property after death. The government should not discriminate against the individual who chooses to dispose of his property after his life ends rather than consume his property during his life, that is, who would rather consume his wealth by giving it to others instead of consuming it himself.

Before ERTA was enacted, the estate and gift taxation laws were a barrier to the continuation of family farms and businesses. A unified credit of $47,000 was allowed against transfer taxes which meant that cumulative transfers of $175,625 could be made without the imposition of transfer taxes. However, the rapid rate of inflation between 1976, when the unified credit was enacted, and 1981 eroded the value of the unified credit and forced estates and gifts into steeply progressive transfer tax brackets. For estates containing farms, ranches, and small businesses, heirs were often forced to dispose of family enterprises in order to pay estate taxes. Some businesses would be sufficiently successful that their heirs could borrow against the business to pay the taxes which were due. Although the business would be burdened with a heavy debt load, the family would be able to keep the family farm or business. Many, however, were not so lucky. To these unfortunate families, the death of the parent meant also the death of the family business. The estate taxes were so high that the farm or business had to be liquidated or sold. The law required payment within nine months and because real estate, machinery, work in progress and inventories are usually illiquid, the prices received were often far below actual value.

Proponents of high estate taxes usually argue that the tax reduces concentrations of economic power and wealth. In the context of a family business, distressed by unbearable estate taxes, that is not the case. Instead, the estate tax would force the family to sell its farm or business to a large corporation with the resources to purchase the family's enterprise quickly -- within the required nine months. The effect of the tax, then, is often to increase economic concentration.

ERTA will substantially, albeit temporarily, reduce this sort of problem for small business, but only if the gradual tax reductions currently in the law are allowed to phase in. Presently, the unified credit excludes only estates of $275,000, although by 1987, estates of $600,000 will be exempt. A freeze of the credit now would maintain the estate tax burden on many small family enterprises. The value of the unified credit is extremely important because the transfer tax rates applied to amounts in excess of the credit are so high, beginning at 34 percent for the first dollar taxed above the credit amount.

Before ERTA, the top marginal federal estate tax brackets approached confiscatory levels. Once federal and state tax laws were taken into account, the right to dispose of private property by will had effectively been abolished for decedents in the higher brackets. ERTA's phased reduction to a top 50% rate eliminates the confiscatory nature of the tax and should be preserved.

It should be noted that the expected revenue gains from freezing the top rate at the current 60% level would be quite small. The freeze would, however, act as a powerful disincentive to saving. More importantly, the economy would lose the increased productivity and employment that saving would have caused.

Recent research shows that a primary, and in many cases overriding, reason why people save is so they can leave an inheritance to loved ones.

This is especially true in the case of small businessmen who want to leave a thriving family business to the next generation. Familial pride and love are often more important motivations than personal gain. In fact, the vast majority of savings are not spent during the savers' lifetime.

With this in mind, it becomes evident that high estate taxation rates provide substantial disincentives to save and invest because savings are so sensitive to after-tax returns. Capital formation, of course, is the key to sustained increases in the nation's productivity, output and employment.

The estate tax is, in effect, the third tax on capital. An individual earns income which is taxed. He saves some of his after-tax income, and the income from his savings is taxed again. Savings left to his heirs are then taxed again.

The Chamber supports the idea that taxes should be neutral, that they should be levied in a way that least distorts an individual's economic decision-making. To distort the economic decision-making process by changing relative costs is to introduce inefficiencies and resource misallocations that hinder economic growth. The estate tax, particularly, is a tax that is pervasive and high. It is not neutral. It taxes savings disproportionately and, therefore, is a significant drag on economic growth.

CONCLUSION

Estate tax reform is one of the most important concerns of the small business community. It was one of the recommendations of the 1980 White House Conference on Small Business, and it is a reform which will not be easily relinquished by the small business community.

The family farm and business are the backbone of the American economy. The family farm has made America second to none in agricultural production and productivity. The spirit of hard work and entrepreneurship necessary to success in small business results in the creation and marketing of ideas and inventions that more established corporations would shun.

The Chamber strongly supports S. Res. 126, which seeks to preserve ERTA's tax reforms. Family-owned farms and businesses do not deserve the added taxes which would fall most heavily upon them if these reforms are not preserved.

Senator **Symms**. Thank you very much. All of your entire statements will be part of the record.

Senator Boren.

Senator **Boren**. I think we have just heard evidence again of how important it is to continue the progress we have made and not to slip back because again, we are really talking about the preservation of the family unit as a small unit in our economic system.

I wonder, did you give a statistic as to how many of your members—do we have any concept of how many family businesses would be affected if we were to freeze at the current level instead of going on up to the $600,000 level? Do you have a breakdown of that?

Mr. **Franasiak**. We don't have absolute figures on that, but my reaction, having worked with the small business community over a number of years and interacting with our members, is that a great number of them would be affected. And indeed, when you are talking about a closely held small business or a family farm, you can get up to those numbers fairly quickly.

Senator **Boren**. In terms of its apprised market value.

Mr. **Franasiak**. Yes.

Senator **Boren**. So we really are talking about very significant numbers of businesses that would be impacted, and I think, looking at the chart that we were supplied by the Farm Bureau in the earlier testimony, that the difference created for, say, a $750,000 farm or business, in terms of the tax, is very, very significant and probably would very much be the element that would force the sale of many of these units.

I wonder, Mr. Harper, in your experience in Kansas, how many of the farm and ranch units would it be, maybe a half? How many would you say would potentially be affected by a freeze if it were put on at this point?

Mr. **Harper**. I don't know if it would be half. It would be a substantial amount. I think your statement earlier that the reverse of what people think of as the psychology of the estate tax is really true. I think what we see when ranches are sold because of estate tax purposes is not the large ones; it is the small ones. Usually it is the larger people buying them up.

I think that is a very valid point.

Senator **Boren**. We have seen it all across the board in all kinds of businesses. One of the areas that we worked in, the newspaper business, for example, where it is very much a matter of policy to encourage independent ownership, we have seen tremendous concentrations, something like going from 80 percent down to like 20 percent of the newspapers in the country that are independently owned. They are acquired by the larger organizations because of mainly, concern about estate taxes.

So it operates not only in agriculture, but other kinds of small businesses and across the board.

Mr. Chairman, I want to thank Mr. Harper for his help to Senator Wallop and to myself and to you back when we were working on the changes in the estate taxes with ERTA because he was a very significant help to me and to my staff, and we appreciate your work and that of the association very much in helping to get that accomplished.

With all of that hard work behind us, I think we are all doubly determined that we are not going to lose the benefit of what we have. Instead, we fight to keep it on the books and move to keep that momentum moving forward.

I thank all three of our witnesses.

Senator **Symms**. Thank you very much, Senator Boren.

I appreciate all of you and I think that Senator Boren's thanks certainly goes for many of us. There are many people here in this room that have worked very hard to help us get as far as we have gotten, and it would be absolutely tragic if we lost any ground at all, and I am hopeful that we will be able to maintain what we have done and actually move forward.

I thank you all very much.

The next panel is Mr. Frazer, Mr. Fitch, Suzanne Nordblom, and Stevan Wolf, representing the Small Business Association.

The first witness will be the Forest Industries Committee on Timber Valuation and Taxation, Mr. Frazer.

STATEMENT OF ELEY C. FRAZER III, PRESIDENT, F&W FORESTRY SERVICES, INC. ON BEHALF OF THE FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION

Mr. **Frazer**. Good morning, Mr. Chairman. My name is Eley Frazer. I am from Albany, Ga. I am in the consulting forestry business.

My firm, in which I have two partners, manages or assists in the management of about 250,000 acres of timberland. Last year we directed the planting of about 8 million trees on this 250,000 acres. Many of these trees were planted as a result of the investment tax credit and the amortization provisions that Congress legislated in 1980.

I was born and raised on a small Alabama farm, and this farm has been in our family for five generations. Therefore, I not only work with these people; I am one of them. I believe I understand them, at least in the Southeast, as well as anyone.

Planting and regenerating trees naturally—many of us reproduce our stands through natural means, which requires more planning and is generally less certain than site preparation and artificial planting—is a risky, long-term business. One almost has to have reason other than economic to cause him to plant these trees, especially when an estimated 65 percent of the owners of this land are over 50 years old and probably will not be around when these trees are harvested, anywhere from 30 to 100 years hence.

There is a great incentive for such owners to leave the lands unplanted and pass them into another generation without trees on which their heirs would have to pay inheritance taxes.

In spite of the fact that Congress intended to improve the situation by allowing the timber grower to use the current use valuation, as drafted, the present rules for the application of the current use valuation almost certainly exclude the forest owner.

These factors are discussed in my written presentation. I do, however, want to tell you about one important way in which these regulations hurt the timberland owner, and recommend a simple way to rectify these regulations.

Recently I appraised at death a property that had been put together by a Georgia farmer for use in dairy farming and timber production. His sons, three of them, were working in the dairy and were heirs perfectly eligible for the special use valuation or current use valuation. This land consisted of five parcels. Three of these parcels were used as pastures for cows and two were used for timber production.

Current use valuation was readily adaptable to the pastures because comparable rentals were easily located. For timberland, no rentals were available and the current use valuation could not be used. Here, the very people for whom the law was written are denied its use for a large portion of their business.

Timber sales are not normally made on an annual basis or even every 5 years, but the growth of timber accumulates. In spite of this fact, and in spite of the fact that it is not harvested, this growth can be calculated on a current annual basis and used in lieu of rental in applying current use valuation, in the same manner as current use is applied to comparable rentals on crop or pastureland. The same Federal Land Bank rates could be applied to capitalize the value of the annual growth in the value.

In my opinion, the landowner should then be allowed to sell an amount of timber equal to the growth each year, or some other period, without a recapture penalty, so that he could maintain his forest as a viable producing unit and pay his taxes and expense it out of the growth, not the principal.

In the final analysis, estate tax is a burden on the timber grower and owner that is detrimental to our country. Many times I have seen lands that have been well managed for many years completely stripped of timber and devastated as a result of their liquidation to pay estate taxes.

These lands are not regenerated in many instances, for the owners do not have the capital to do so. Many of them feel that their fathers and mothers worked and sacrificed all their lives to leave something, and often they did, which the Government has destroyed through inequitable taxation. They do not intend to make the same mistake.

Gentlemen, we held a meeting in Atlanta 3 years ago where 96 landowners from 13 States in the South were asked, without being influenced by professionals, to make a list of the action most needed to encourage them to produce timber. The owners were divided into 10 groups. At the top of the list in each and every group was tax relief, with estate tax having the highest interest.

You now have a chance to benefit our timber supply in a manner comparable to the benefit received from capital gains changes in 1944. I plead with you to make these same benefits available to timber farmers that you have made to other farmers. If you do this, there will be no shortage of wood in 2030.

I would like to delete the last paragraph on page 10 of my written statement. Thank you.

[The statement of Mr. Frazer follows:]

STATEMENT OF

ELEY C. FRAZER, III
PRESIDENT
F & W FORESTRY SERVICES, INC.

ON BEHALF OF THE

FOREST INDUSTRIES COMMITTEE ON
TIMBER VALUATION AND TAXATION

BEFORE THE

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

COMMITTEE ON FINANCE

UNITED STATES SENATE

WASHINGTON, D. C.

JUNE 27, 1983

Mr. Chairman, I appreciate very much this opportunity to testify on behalf of the Forest Industries Committee on Timber Valuation and Taxation. Our Committee speaks on behalf of more than five million forestland owners of all sizes from all regions of the country and for the many associations representing them in various respects. These associations are listed in Appendix A. In particular, the staffs of the National Forest Products Association, the Southern Forest Products Association, and the Forest Farmers Association participated in the preparation of this testimony.

The principal public policy objective of our Committee is the attainment and preservation of equitable federal tax provisions that reflect the long-term nature of forest investments and the unique risks involved.

We come here today to emphasize one simple fact: The federal estate tax laws must be changed if we are to assure our nation an adequate timber supply. Excessive federal estate taxes provide a substantial disincentive to reforestation and force premature harvesting of our nation's private forestlands. To this extent, our tax policy interferes with attainment of the wood and fiber requirements of future generations of Americans.

I. Ensuring Timber Supply: A National Goal

We start with the premise that ensuring an adequate timber supply is a vital national goal.

A. Timber Supply and Demand

The Forest Service estimates that domestic demand for paper and wood products may double by the year 2030, with the demand for paper and wood products climbing from 13.4 billion cubic feet in 1976 to 28.3 billion cubic feet by 2030.[1] Table I summarizes the projected supply/demand situation:

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[1] In part because of the hazards of making estimates of what is likely to occur fifty years hence, the Forest Service has assumed three alternative economic and demographic scenarios for its estimates. Thus, based on these scenarios, the Forest Service has developed three alternative possible future demand levels -- low level demand, medium-level demand, and high-level demand. The data presented in this testimony depicts the results that will ensue on the basis of medium-level demand.

Table I

Summary of U.S. supply and demand for softwoods and hardwoods in 1976 and for 2030 2/

Category	Billion Cubic Feet 1976	2030
Softwoods		
Total U.S. demand	10.4	18.7
Exports	1.6	.9
Imports	2.5	3.9
Demand on U.S. forests	9.5	15.7
Supply from U.S. forests	9.5	12.3
Supply/demand balance	0.0	3.4
Hardwoods		
Total U.S. demand	3.0	9.6
Exports	0.2	0.4
Imports	0.3	0.6
Demand on U.S. forests	2.9	9.4
Supply from U.S. forests	2.9	8.9
Supply/demand balance	0.0	-0.5
All timber		
Total U.S. demand	13.4	28.3
Exports	1.8	1.3
Imports	2.8	4.5
Demand on U.S. forests	12.4	25.1
Supply from U.S. forests	12.4	21.2
Supply/demand balance	0.0	-3.9

Source: U.S. Forest Service

One reason that insufficient timber supplies 3/ are projected for the future is because excessive Federal

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2/ Assumes medium-level demand (see note 1, supra) and price increases, net of inflation, similar to those experienced from late 1950's to mid-1970's.

3/ Because supplies will be insufficient to meet projected demand, prices of stumpage will increase to produce equilibrium

(Continued)

estate taxes have deterred reforestation and have forced premature harvesting on our nation's private forestlands.

B. Importance of Timber Growing to National Economy

Over 5,000 consumer products are derived from our forests--commodities which are essential to education, communication, sanitation and health and many of which contribute in unique ways to the maintenance of the American standard of living. A side benefit is that growing forests contributes significantly to the overall ecosystem.

Forest Service statistics show that for every dollar that is invested in timber management, a total of $17 is generated in other economic activity. This is illustrated in Table II.

(footnote 3 continued)

(*i.e.*, prices will rise so as to reduce demand to match supply). Net of inflation and deflation, the Forest Service estimates that by 2030, the price of stumpage will vary regionally, as a percent of 1967 constant dollars, between 280% to 1045% for softwoods, and between 105% to 203% for hardwoods.

Table II

Estimated value added and employment
attributable to timber
in timber-based economic activities, 1972

Economic activity	Value Added (MMM$) Attributed to timber	(Employment MM People) Attributed to timber
Timber management	2.9	0.1
Harvesting	3.1	0.2
Primary manufacturing	8.8	0.4
Transportation and marketing	9.3	0.8
Secondary manufacturing	12.5	0.9
Construction	11.9	0.8
Total	48.5	3.2

Source: U.S. Forest Service.

The reference to "timber management" in Table II indicates that the value of timber that was harvested in 1972 was $2.9 billion on the stump. Harvesting added $3.1 billion in value, primary manufacturing added $8.8 billion, etc.

Thus, incentives to help private nonindustrial forest owners manage their lands will benefit the entire nation.

C. Impact on Inflation

If our tax policies create a reduction in timber production, severe shortages may result. Historically, such shortages have exerted pressure on the price of wood building materials and housing. The effects are felt throughout the entire economy.

The Forest Service has quantified the magnitude of price increases that may be expected by 2030. Net of inflation and deflation, and depending upon where in the country the timber is located, prices are expected to vary between 280 percent and 1045 percent of 1967 levels for softwoods and between 105 percent and 203 percent of such levels for hardwoods.

D. Balance of Payments

In 1979, exports of timber products amounted to $6.9 billion -- almost 4 percent of total U.S. merchandise exports. This level of exports, however, might be greatly enhanced and could go a long way toward improving our balance of payments.

In commenting on this potential in a 1979 issue of *Fortune* magazine, Lee Smith observed the following facts:

> The United States is peculiarly well endowed to be the most efficient producer of useful wood in the world. Competitors, chiefly Canada, Scandinavia, the U.S.S.R., and Brazil, all have special strengths, but no other country has such a favorable combination of advantages as the U.S., including high-quality species of trees, warm climate, relatively low labor costs, an

> extensive transportation network, and abundant factories to turn trees into everything from Pampers to rocking chairs.

E. Difficulty in Attracting Capital

It is estimated by the Forest Service economists that an investment of $10.6 billion would be required to adequately stock or convert the 124 million acres of privately owned nonindustrial timberlands which are non-stocked, poorly stocked, or in need of conversion to another species. Such an investment would result in a net gain in annual growth of 9.1 billion cubic feet.

Unfortunately, however, forest landowners know all too well the hazards of forest investments. You hear these kinds of comments:

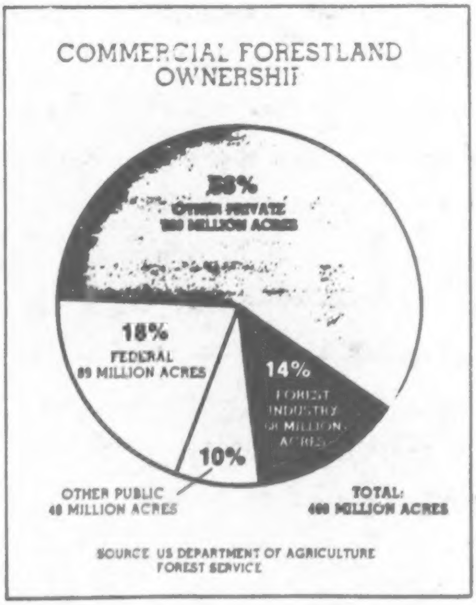
1. I'll die before the trees are old enough to cut.
2. There is too much risk of fire, disease, and storms. Casualty loss insurance is simply not available on standing timber at any price.
3. The initial capital investment costs (land preparation, roads, plantings) and annual maintenance costs are higher than ever before.
4. There is no annual income, like rents or dividends.
5. I'm scared that Uncle Sam will take whatever profits I make away from me with confiscatory taxes.

Easing the burden of estate taxes would be an important step in correcting the problem outlined above.

II. Increase in Timber Supply Must Come From Private Nonindustrial Landowners

Table III shows the distribution of forestland ownership in this country. Of the categories shown, the greatest potential for increased production comes from the 278 million acres owned by 5 million private landowners. In general, these lands are not intensively managed for timber production and produce wood at only about 63 percent of their potential.

Table III



SOURCE US DEPARTMENT OF AGRICULTURE FOREST SERVICE

In contrast, public lands are under constant pressure for uses other than commercial forestland. Harvest levels are nearly static and funds perennially have not been provided for adequate forest management. The industry lands comprise only 14 percent of the total and are producing at close to their full potential. It is therefore less feasible to achieve significant improvements in timber production from industrial or public lands than from nonindustrial private lands.

III. Tax Policy: An Effective Incentive

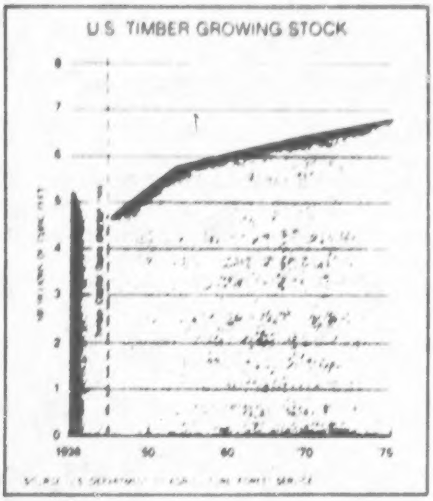
In any discussion of the impact of tax policy on forest productivity, it is essential to emphasize at the outset that absent the same capital gains treatment that is applicable to all capital assets, there are no ongoing special tax benefits for growing timber.

In 1944, Congress extended capital gains treatment to the full range of qualified timber transactions rather than only to lump sum, liquidation-type sales. What followed was the most dramatic change in growth and planting in the history of American private forestry.

Tables IV and V show the impact in terms of U.S. timber growing stock and annual plantings in private forests. Prior to 1944, seven billion cubic feet more timber was harvested than was grown annually. Since 1944, we have grown an average of over four billion cubic feet more than we harvested each year, a substantial net gain.

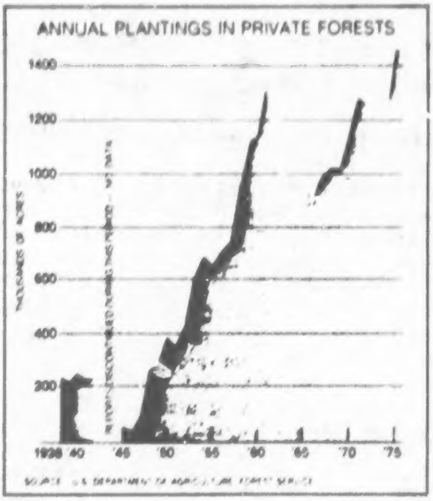
And, in the case of planting, annual plantings on private lands have increased from practically zero to over one million acres per year.

Table IV



SOURCE: U.S. DEPARTMENT OF AGRICULTURE, FOREST SERVICE

Table V



SOURCE: U.S. DEPARTMENT OF AGRICULTURE, FOREST SERVICE

This growth has added to the property tax base at state and local levels. A survey of industrial timber owners indicates that these taxes average $8.08 per acre, which, extrapolated to the 278 million acres owned by nonindustrial owners would suggest total state and local property tax payments in excess of $2 billion.

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IV. Why the Current Estate Tax Cuts Down Productivity on Private Nonindustrial Forestlands

The current estate tax lowers productivity for two basic reasons.

First, the estates of landowners are often forced to cut timber before its proper time in order to pay the estate tax. Cutting younger trees before they have reached optimal harvestable size is bad management. Depending on the region, tree species and forest management practices, timber crops take between 30 and 100 years to reach harvestable size. It is during the latter part of this lengthy growing period the timber will be increasing in value most rapidly. Rapid liquidation of timber just to meet tax liabilities is bad forestry in that it may not coincide with either optimal biologic or economic management considerations.

The second reason the estate tax lowers productivity is that it discourages reforestation. An owner usually will replant solely in order to benefit his heirs. I emphasize again, the average growing time for mature trees ranges from 30 to 100 years, which is usually long after the death of the planter. Yet, before the trees grow to a size that will yield a fair return, the owner will die and the trees will be cut in order to pay estate taxes. Neither the owner nor his heirs may ever see a fair return on the initial investment.

A recent survey by the Forest Service of private nonindustrial land owners in the South who had harvested their timberlands empirically confirms the adverse impact that the estate tax has on the decision to reforest. Over three-quarters of the respondents indicated that reducing the burden on heirs by lowering inheritance and estate taxes would have a high to moderate effect on their decision to reforest, with 20 percent indicating that more favorable inheritance or estate tax laws would have the greatest favorable impact on encouraging them to reforest.

These results are further underscored by an American Forest Institute survey which shows that 37 percent of all tree farmers in 1972 were over 60 years old and 28 percent were between 50 and 60 years of age. This data indicates that 65 percent of the owners of private forestlands could be involved in estate tax proceedings between now and the end of the century. Thus, the impact of the estate taxes on timber owners may be larger than for other asset groupings with a different ownership pattern.

The result of this scenario is a matter of simple economics. We have reached the point among timber owners where the obvious adverse economics are redirecting investments away from forestry. Owners are shying away from replanting after harvest and intensive management is being curtailed.

V. The 1981 Amendments and the AHCET Position

In 1981 after substantial testimony before this Subcommittee, significant estate and gift tax relief was provided by the enactment of the Economic Recovery Tax Act of 1981 (ERTA). Not all of this relief was effective immediately, however, as major areas of estate tax reductions were to be phased-in: the maximum credit was to be increased over six years to an effective exclusion of $600,000, and the maximum tax rate was to be decreased over four years to 50 percent. These two improvements will go a long way toward encouraging many timber owners to undertake the required reforestation and toward providing the estates of others the means by which to retain and manage the decedent's timberland.

Unfortunately, some in Congress have proposed freezing both the credit and maximum tax rate at current levels. This would provide a credit equal to merely a $275,000 exclusion and a maximum tax rate of 60 percent.

We join the Ad Hoc Coalition on Estate Taxation (AHCET) in its support of S. Res. 126, which expresses the sense of the Senate that such a freeze would be inappropriate. We are especially grateful for the support of you Mr. Chairman and the other members of this Subcommittee who are opposing the freeze.

We also join with AHCET in noting that further estate and gift tax relief is necessary, when the time is appropriate. We recognize, however, that with the exception of the repeal of the generation skipping provisions which would cost little in revenues, more substantial reductions may be required to await the bringing of the deficits under control.

Nevertheless, we believe that there are specific amendments that might be made now to assist timber owners, the cost of which would be negligible. These include specific amendments to Section 2032A and Section 6166.

VI. Section 2032A

We believe that Section 2032A, which provides for the special use valuation offers an effective means to reduce the excessive tax burden on timberlands. Section 2032A of the Code was clearly intended to provide at least a measure of relief by placing a lower special use valuation on woodlands, as well as other farmlands. As a practical matter, however, special use valuation provides little relief to most private timberland owners.

A. Material Participation Requirement (Section 2032A(b)(1)(C)(ii)

Currently, Section 2032A(b)(1)(C)(ii) requires the decedent or a member of his family to have "materially participated" in the operation of the timberland to qualify for special use valuation. It is extremely difficult to meet this requirement in the case of timberland, since most privately owned timberland operations do not require day-to-day management decisions and material participation of the owner. In such cases, the material participation requirement should not be applicable to timberland. We would urge that Section 2032A be amended to achieve this result. A comparable proposal was made by Senator Wallop in S. 395, introduced during the 97th Congress.

B. Special Use Valuation Methods (Section 2032A(e)(7) and (8)

A critical problem in applying Section 2032A involves the methods currently used for arriving at the special use valuation. Current law under subparagraph (e)(7) permits farm property to be valued on the basis of the average annual gross cash or net share rental for comparable property. This valuation method is virtually meaningless in the case of timberland. Often there is no comparable property for which cash rental figures can be obtained. And share rentals of timberland are infrequent. Finally, the formula in (e)(7) does not work well because timberland does not produce a recurring annual crop. Rather, timberland is harvested in commercial quantities only infrequently.

When Section 2032A(e)(7) does not apply, the estate must value the property pursuant to Section 2032A (e)(8), which provides a five factor test. While this latter provision is also intended to provide a current use valuation, it does not work well for timberland.

Let me give you an example that illustrates the contrast between the methods provided in subsections (e)(7) and (e)(8). I recently appraised on behalf of an estate a dairy farm consisting of five parcels. Three of these parcels were open land and two of the parcels consisted of timberland.

I had no difficulties with respect to the three parcels of open land; Section 2032(a)(e)(7), which permits the valuation to be made by a comparable rental method, provided a value below the fair market value that reflected the property's current use.

There was, however, no comparable rental for the two parcels of timberland. Therefore, I was forced to use the five factor test provided by Section 2032(A)(e)(8), the application of which resulted in valuing the land at its fair market value -- not its current use value.

To solve this problem, Section 2032A ought to be amended to provide an additional special use valuation formula that an executor may elect for timberland. This formula should determine the special use valuation by dividing:

(i) the excess of the average annual income which the property can be expected to yield in its current use over the amount of the average annual State and local real estate taxes for such qualified real property, by

(ii) the average annual effective interest rate for all new Federal Land Bank loans.

The computations made under the preceding sentence shall be made by determining the expected yield over a reasonable period of time under prudent management, taking into account current stocking, soil capacity, terrain configuration, and similar factors.

This alternative is comparable to the approach taken in current Section 2032A(e)(8)(A). But Section 2032A(e)(8)(A) does not by itself determine the current use value. Rather, it provides only one of the five factors of (e)(8) that current law requires to be taken into account in the valuation of qualified real property.[4] And section 2032A(e)(8)(A) merely provides for the capitalization of estimated income from the property. It does not fix the capitalization rate at the average interest rate for new Federal Land Bank loans, nor does it permit the estimated annual income to be reduced by resl estate taxes, costs which must be paid if the income is to be realized.

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[4] This method is further supported by a recent U.S. study. See U.S. Economic Commission for Europe Effect of Taxation on Forest Management and Roundwood Supply, (50-51) XXXIII Timber Bulletin for Europe (1980 Supp. No. 4).

In addition, we support AHCET's suggestion that another alternative be provided for situations where the executor either cannot or does not use the aforementioned formula. Section 2032A should be amended to provide a "safe-harbor" whereby the executor may simply value the qualified property at 50 percent of its fair market value.

Finally, it is not clear under current law whether an election to use a particular method of valuation is irrevocable. Because of disputes that may arise in audit concerning certain aspects of formula valuation, it may be advantageous for an executor to change his method of valuation. As a solution to this problem, we suggest allowing an executor to change his method of valuation on an amended return at any time before the statute of limitations for assessing additional estate tax has run.

C. Special Woodlands Recapture Tax -- Section 2032A(c)(2)(E)

In 1981 ERTA attempted to rectify what had been a severe problem for many timber owners. The Internal Revenue Service had interpreted the definition of real property under Section 2032A to include only the land underlying the timber, not the timber itself. As a result, many estates consisting of substantial amounts of timberland were excluded from eligibility for the special use valuation since the value of the mere land was not sufficient to meet the threshold eligibility requirement that 25 percent of the value of the gross estate consist of qualified real property.

ERTA attempted to solve this problem by adding a new paragraph -- Section 2032A(e)(13) -- which provides an election, the effect of which is to deem the trees to be real property. This amendment, by itself, would have been extremely helpful. Unfortunately, ERTA also added by Section 2032A(c)(2)(E), which provides an onerous special rule for computing the recapture tax that is applicable when the election under Section 2032A(e)(13) has been made.

Generally, Section 2032A imposes a recapture tax on all estates that have elected the current use valuation if the property specially valued is disposed of within a ten-year period from the decedent's death. Where all the property specially valued, including timber, has been disposed, the amount of the recapture tax is equal to the estate tax savings. And in the event of a partial disposition of property other than timber, only a portion of estate tax is recaptured. The amount of tax recaptured in such case will always be less than the amount realized on the sale (unless the amount realized on the sale is less than the fair market value of the property.) However, in the event of partial disposition of timber -- i.e., the sale or cutting within a ten-year period of any trees -- the amount of tax recaptured may potentially equal the full amount realized on the disposition. While this computation is extremely complex (see Appendix B), suffice it to say that the recapture tax computed under the special recapture rules for timber often will exceed of the recapture tax computed under the general rules.

This disparity is of more than academic concern. Since virtually every well-managed timber stand will have at least some cutting for management purposes within a ten-year period, virtually all estates making the special timber election will be subject to the recapture tax. But the convolutions required to sort out the amount of the tax to be recaptured are extremely forboding for small estates -- the very ones intended to be benefitted by this provision. In fact, the costs of professional tax assistance may well dwarf the benefits of the election. As a result, many executors deline to use the special use valuation, despite its applicability to their estates. We would therefore urge the deletion of the special recapture rule for timber, and propose that timber be made subject to the same recapture rules as other taxpayers.

VII. Section 6166

Section 6166 extends the time for payment of estate tax where the estate consists largely of an interest in a closely held business. And where Section 6166 applies, up to $1 million of the unpaid tax incurs interest at a preferential interest rate. In order to be eligible for the benefits of Section 6166, the decedent must have been carrying on a "trade or business" either as a proprietorship, within certain partnerships, or within certain privately held corporations.

The deferral of the time for payment of estate taxes would be extremely helpful for those who inherit timberland -- an extremely illiquid asset. It would permit them to manage this land appropriately, and through periodic payments, would enable them to satisfy their estate tax obligations without requiring the forced liquidation of the timber.

For many timber owners, however, the "trade or business" test is often difficult to meet. Because most privately owned timberland operations do not require the day-to-day involvement of their owners, it is unclear whether the decedents' activities meet the formalistic requirements of a "trade or business." Thus, despite a timber owner's truly being in the business of growing timber for sale, the Service may in some cases view his business to be ineligible for the benefits of Section 6166. Timber owners should be treated no less favorably than the owners of other types of businesses.

We would urge that Section 6166 be amended to permit an estate that would qualify for the deferral but for the "trade or business" requirement be deemed eligible if the activity involved is growing timber.

VIII. Reforestation Provisions

Finally, while not an estate or gift tax problem, we would like to mention briefly an inequity that arises where trusts, created either by decedents or through inter-vivos transfers, own timberland.

In 1979, Congress added to the Code Sections 194 and 48(a)(1)(F), the effect of which is to permit investments of up to $10,000 in reforestation to be amortized and to be eligible for the investment tax credit. Solely because of technical difficulties, however, these benefits were denied to trusts.

We have since prepared the outline of a proposal, attached as Appendix C, which would extend these incentives to trusts, and which meets the technical concerns that were raised in 1979. We would urge the Committee to consider it for inclusion in the next technical corrections or miscellaneous revenue bill.

IX. Summary

The current estate tax law interferes with our attainment of an adequate supply of wood and fiber for the future. The estate tax law should be amended so that it encourages reforestation and proper management techniques.

We believe that amendments to Section 2032A, the special use valuation provision, and to Section 6166, the extension in time to pay the estate tax, are steps in the right direction. Most importantly, we support S. Res. 126 and strongly urge that efforts to freeze the now scheduled estate and gift tax relief be repelled.

Senator SYMMS. Without objection, it will be deleted. Thank you very much for your excellent statement. I certainly agree with you. This subject has come up oftentimes in the Budget Committee, where there are a couple of my colleagues who are critics of any kind of tax treatment of forest products. When one brought the question up, why would timber be treated this way, I made the statement that only those people that like trees, and I think that certainly what you are asking is certainly consistent with what most people would consider good environmental policy.

If we do expect to have the wood products and the trees in the country, then we have to recognize the necessity for fair tax treatment or there is just no way that people can afford that long-term investment and the long-term consistent growth patterns that are necessary to provide the wood products for the country.

Thank you very much.

Mr. John Fitch, vice president, Government relations, the National Association of Wholesaler-Distributors, Washington, D.C. I welcome you also to the committee, Mr. Fitch.

I might just note that oftentimes, people think that it is only farmers and ranchers that are interested in the death tax, which works against the small businessman no matter what they do, and I understand here you represent 120 national commodity line associations and 45,000 wholesaler-distributor members. So we welcome you to the committee.

STATEMENT OF JOHN H. FITCH, JR., VICE PRESIDENT, GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

Mr. FITCH. Thank you, Senator.

The estate tax laws very definitely fall heavily on closely held businesses, particularly ones that are family-owned. And it is on that premise that I am here today.

There is a crisis of perpetuation for the small, family-owned wholesaler-distributor. Each succeeding year it becomes harder and harder to continue the independence of the business and keep it within the family structure under today's estate tax laws. Unless efforts such as yours here today and as were accomplished in 1981 are successful, the entrepreneurial uniqueness of America's free enterprise system will wither and die and with it will go much of the competitive and innovative nature of our economy.

The National Association of Wholesaler-Distributors strongly supports the retention of the estate tax reductions enacted in the Economic Recovery Tax Act of 1981. And, as a member of the Ad Hoc Coalition on Estate Taxation, who testified earlier, we support the following legislative initiatives which would further reform the current estate tax laws.

No. 1, broaden the current unlimited marital deduction into a family deduction to allow for the passing of a closely held business to the children without taxation.

Index current estate tax brackets and the unified exemption, once fully phased in, to counter bracket creep that occurs as a result of inflation.

Reduce the top tax rate from 50 percent to 20 percent and conform the lower brackets accordingly. We would also make a recommendation that if that is not possible, that a flat rate for all estates whose value exceeded the exemption should be enacted, rather than the current graduated approach.

Finally, I wish to emphasize NAW's strong support for Senate Resolution 126, which you, Senator Boren and Senator Wallop have sponsored, and its companion measure in the House, House Resolution 216, which oppose any freeze on the 1981 estate tax reductions which have not yet been phased in.

Thank you.

[The statement of Mr. Fitch follows:]

STATEMENT

JOHN H. FITCH, JR.
VICE PRESIDENT-GOVERNMENT RELATIONS
NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS
COMMITTEE ON FINANCE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
June 27, 1983

FULL STATEMENT

Mr. Chairman, Members of the Subcommittee, this statement is presented on behalf of the wholesale distribution industry by the National Association of Wholesaler-Distributors. My name is John H. Fitch, Jr., Vice President-Government Relations for NAW. I would also like to indicate that NAW is an active member of the Ad Hoc Coalition on Estate Taxation and, as such, to officially associate ourselves with their comments.

Mr. Chairman, before I get into the substance of my statement, I would like to commend your efforts and those of the Subcommittee to address the crisis of perpetuation. For the small, family-owned wholesaler-distributor, it is difficult to continue the independence of the operation and keep it within the family structure.

Unless the estate tax reductions enacted in 1981 are preserved and improved as suggested herein, the entrepreneurial uniqueness of America's free enterprise system will wither and die, and with it will go much of the competitive and innovative nature of our economy.

NAW

The National Association of Wholesaler-Distributors is a federation of 120 national wholesale distribution associations[1] which have an aggregate membership of approximately 45,000 wholesaler-distributors, with 150,000 places of business.

The members of our constituent associations are responsible for 60% of the $1 trillion of merchandise which will flow through wholesale channels this year, according to the Commerce Department. They employ a comparable percentage, or 3 million, of the 5 million Americans who work in wholesale trade.

Although the individual firms which our organization represents are small- to medium-sized businesses individually, their collective economic importance is most significant.

The Industry

The wholesale distribution industry, in contrast to the manufacturing sector of the economy, continues to be dominated by small- to medium-sized, closely held, family-owned businesses. Of the

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[1] Appendix A.

238,000 merchant wholesaler-distributor corporations in the United States, 99% had assets of $10 million or less. These smaller firms accounted for about 58% of the industry's sales volume. In contrast, in the manufacturing sector, approximately 2% of the firms controlled about 88% of the assets and accounted for approximately 80% of sales.

The wholesale distribution industry provides year-round employment for over 5 million individuals. Average hourly earnings ($6.78) in wholesale trade exceeded those for all private industry ($5.14), while average weekly earnings ($212) were 15% above those in private industry ($185). In short, the wholesale distribution industry provides dependable, well-paying jobs throughout the U.S. economy.

Industry sales totaled approximately $1.2 trillion in 1982 and are expected to reach over $1.4 trillion in 1983, according to United States Commerce Department estimates.

A 1982 profile of the wholesale trade, as compiled by the U. S. Department of Commerce from Census Bureau figures, shows the following:

SIC CODES: 50-51

Sales (million $)	1,163,400
Employment (000)	5,290
Number of establishments	307,264

Compound annual rate of growth, 1972-82:

Sales (percent)........................	12.6
Employment (percent)....................	2.5
Payroll (million $).....................	72,000

Merchant wholesaler-distributors perform an essential economic function. They make goods and commodities of every description available at the place of need, at the time of need. Wholesaler-distributors purchase goods from producers, inventory these goods, break bulk, sell, deliver, and extend credit to retailers and industrial, commercial, institutional, governmental and contractor business users.

Wholesaler-distributors are essential to the efficient satisfaction of consumer and business needs. Further, by the market coverage which they offer smaller suppliers and the support which they provide to their customers, wholesaler-distributors preserve and enhance competition, the critical safeguard of our economic system. According to an NAW survey, the typical wholesaler-distributor established the market connection between 133 manufacturers and 533 business customers. Many of these manufacturers are themselves small businessmen who must rely on wholesaler-distributors to establish, maintain, and nurture markets for their products. The majority of customers are small businessmen, also, who look to the merchant wholesaler-distributor to provide merchandise availability, credit and other critical services.

ESTATE TAXATION AND THE WHOLESALE DISTRIBUTION INDUSTRY

In 1973, NAW initiated a broad study to gain a precise understanding of the actual ownership and perpetuation status of wholesaler-distributors[2].

The survey involved 38 commodity line associations and was distributed to 18,000 firms. An astounding 5,000 responses were received, of which 4,700 were usable for the computerized analysis. The study was conducted by Robert C. Bansik, Ph.D., and Harold Squire, Ph.D., of the Capital University Graduate School of Business Administration in Columbus, Ohio. Data collected through the study revealed much about the individual wholesale distribution business and its ability to exist in its present form beyond one generation. The following typical ownership profile was determined from the survey results:

1) The firm has a net worth of between $250,000 and $499,000.

2) The Chief Executive Officer (CEO) himself owns from 51 to 74 percent of the firm's outstanding stock.

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[2] A copy of the full study is available from NAW upon request.

3) The CEO is between 50 and 59 years of age.

4) The CEO's personal maximum federal tax bracket is in the range of 35 to 49 percent.

5) His ownership in the company represents from 51 to 74 percent of the CEO's personal net worth.

6) Less than $100,000 in life insurance on the CEO is owned by the corporation, and payable to it upon his death.

Although the study was conducted in 1973, its conclusions remain valid today. Indeed, the situation has even more urgency associated with it due to mortality figures since the law was last revised in 1981.

Based upon the determination of the typical ownership profile, the NAW Perpetuation Survey sought to answer the following question: "What is the likelihood that this firm can be perpetuated beyond the life of the present chief executive officer, in its present form?" The researchers concluded that: "In fact, given the present situation of U. S. inheritance/estate taxation and valuation, perpetuation in its present form may be highly unlikely."

The urgency of this problem cannot be emphasized strongly enough. Standard mortality tables, accurate to within a fraction of a percent, permit a very realistic projection of how many people, in various age groups, will die during any future specified period. Based on the "Commissioners' Standard Ordinary Table of Mortality," in conjunction with age data provided by the NAW Perpetuation Survey respondents, it was determined that at least 61 of the almost 4,700 owners replying would die by the end of 1975. Chief executive officers of the firms surveyed are dying at the rate of at least one per week.

Table 1

AGE DISTRIBUTION AND MORTALITY

Expected Deaths by 1985

Age Reported	Number Reporting	Actuarial Age	Deaths by 1985
Under 40	423	40	22.0
40-49	1235	45	147.1
50-59	1817	55	359.1
60+	1266	60	364.4
			892.6

Source: NAW Perpetuation Survey, 1975.

Moreover, the study also showed that nearly 8 percent -- or 363 -- of the owners responding would die before 1980. As Table 1 shows, 19 percent, or 893, will have died before 1985. The figures may be morbid, but they are clear: one in every five chief executive officers of wholesaling firms faces death before 1985. The statistical figures shown are for general mortality;

we would expect data for stressed businessmen to be higher -- accelerating the death rates for the respondents of the survey.

Over the years, the problem of perpetuation has gained in prominence for the owner or chief executive officer of a wholesale distribution concern as he plans for the disposition of his estate upon his death. The tax crunch resulting from present estate taxes becomes a major concern to everyone faced with this problem. The tremendous estate tax liabilities, which are certain to come due upon the death of a principal owner of the small wholesale distribution business, leave the heirs of the estate with few options -- pay up with cash on hand, or sell or merge the business to generate the needed amount of cash.

Payment of the estate tax, regardless of which methods are employed, will adversely affect the economic health of the small business community -- by reducing the funds available to the smaller business for continued growth, or by outright extinction of the small business firm through sale or merger.

Public policy has a tremendous impact on the preservation of a viable small business community in our nation, and on the unique needs and problems of the small business community. This has been recognized by the Congress, as is evidenced by the creation of the Small Business Administration, whose sole purpose is the preservation of a viable small business sector in the economy; the establishment of Small Business Committees in both the House and the Senate; the enactment of various small business oriented statutes; and the introduction each year of numerous legislative and regulatory measures specifically designed to aid small businesses.

Despite this recognition and awareness on the part of the federal government, nothing can protect large numbers of small businesses from dying a gradual death unless reform measures are enacted to mitigate the impact of estate taxation on small business. We recognize the fact that the estate tax system was never intended by the Congress to impact in any adverse manner on the small business community. However, the application of the law in today's economy has in fact done so -- a consequence completely at variance with the intent of the Congress.

Repeal of Estate Taxes

While we recognize the validity of the original purposes for the enactment of the estate tax laws: (1) as a revenue source; (2) to increase mobility and redistribute wealth; and (3) to enhance the progressivity of the overall tax system, these purposes have lost most, if not all, of their validity.

As a source of revenue to the Treasury, estate taxes provide precious little contribution; 1977 Treasury statistics show that estate taxes provided only 1.4 percent of total federal revenue in 1977.

As a tool for social reform, it is my opinion that since the enactment of the Tax Reform Act of 1916 when the present tax was first imposed, the number and percentage of those actively participating in the economic system has substantially increased. Moreover, Treasury figures show that the quality of that participation has also increased over the broad scope of our social spectrum. Thus, the necessity to prevent large accumulations of wealth from being passed along untouched by taxes to succeeding generations consequently reducing the mobility of other segments of society is passed. The goal has been achieved.

With the advent of this affluence came an increase in personal spending and a reduction in savings and investment, which have been exacerbated by inflation and government disincentives such as estate taxes and taxes on interest and dividends. The obvious result of that collective environment is the current disastrous economic situation in which our members find themselves today.

A barrier to savings, estate tax runs counter to what the Administration and Congress are trying to accomplish with the recent budget cuts, tax reform and regulatory reform. It is clear that the social goals have changed from mobility and redistribution of wealth to savings, investment, and preservation of independent family farms and closely held businesses.

Finally, estate taxes distort normal processes which small businesses' owners and others would otherwise use in the distribution of their estates upon death.

In our opinion, the evidence, as outlined above, is overwhelmingly in favor of the total abolition of estate taxes.

If, in fact, the repeal of estate tax laws is not feasible at this time, NAW would urge, at a minimum, the retention of the estate tax reductions enacted in 1981 as part of the Economic Recovery Tax Act but which have not been fully "phased-in".

In this regard, NAW strongly supports S. Res. 126 sponsored by you, Mr. Chairman, and Senators Wallop and Boren which opposes any elimination or freeze of those "non-phased-in" portions of the 1981 estate tax reductions.

If the recent "merger mania" troubles Congress, eliminating or freezing the 1981 estate tax reductions will only exacerbate the problem.

Estate Tax Exemption

The burden of estate taxation has fallen increasingly on small businessmen and other middle-income taxpayers in recent years. The basic cause for this has been the long-term inflationary trend in our economy. No one needs to be reminded of the tremendous erosion which has occurred in the value of the dollar over the years. To illustrate the debilitating effect of inflation on the wholesale distribution industry, the Distribution Research and Education Foundation commissioned a study[3] by the senior faculty at the Graduate School of Business of the University of Michigan. The results of that study clearly reflect the need to take immediate steps such as estate tax reform, to alleviate this critical problem. Inherent in this inflationary trend is the fact that the cost of dying has also increased. Changes in the income tax exemption have been made numerous times over the years to account for the rising cost of living, but the corresponding changes made in the level of the estate tax exemption have not kept pace.

Therefore, NAW recommends that the exemption once fully phased-in be indexed against inflationary erosion as was done with the income tax exemption and brackets.

This inflationary erosion of the estate tax exemption has led to serious structural changes in the free market system. That is, smaller businesses, because of the estate tax laws, have less opportunity to remain independent and grow into medium-sized or even larger businesses.

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[3] Copies of this study, Inflation in Wholesale Distribution are available from NAW.

Estate Tax Rates

Another aspect of estate taxation which requires examination is the rate structure. This structure is clearly a highly progressive tax, with marginal tax rates spanning from 18 to 50 percent (once fully phased-in). However, a close examination of the tax rates shows the sharpest rise in progressivity occurs in the lower rate brackets, while the upper brackets increase only mildly.

Clearly, the impact of the estate tax on the lower brackets seems unfairly severe.

A clear example of this can be seen when one examines the tax rate on $500,000 -- 32 percent. Yet, the rate on twice that amount -- $1 million -- is only 37 percent. It can easily be seen that inflation has severely distorted the rate structure, resulting in an effective rate of taxation completely foreign to that originally enacted. Thus, in practice, the marginal tax rates have also been raised due to inflation; i.e., estate tax bracket creep.

In the interest of returning parity to the estate tax structure, NAW recommends that Congress index the tax brackets to obviate bracket creep generated by inflation using the same approach enacted in the 1981 Economic Recovery Tax Act for the individual tax rates.

Moreover, NAW recommends a further reduction of the top tax rate from 50% to 20% with comparable reductions in the lower brackets, or, in the spirit of simplicity, eliminate the brackets altogether and establish a single flat rate for all estates or portions thereof falling outside the $600,000 exemption.

Table 2 presents an analysis of the effects of this "bracket creep" phenomenon on the average wholesale distribution firm.

The heirs of a family-owned distribution firm will naturally look to the business to pay the estate taxes attributable to the business. In our example, we have considered the business asset as representing the entire estate (this allows for the application of the full exemption and the lowest possible rate of estate taxation).

Table 2 shows the average asset size and net income for the typical wholesale distribution firm in the $250,000 to $500,000 asset grouping, as derived from the Treasury Department's Statistics of Income Series, the latest year for which data are available.

Table 2

IMPACT OF ESTATE TAXES ON TYPICAL WHOLESALE DISTRIBUTION FIRM ASSET SIZE CLASS

Asset Size	$250,000-500,000
Average Asset	$359,031
Less Exemption	$275,000
Taxable Estate	$ 84,031
Estate Tax	$ 18,925
Net Income After Tax	$ 18,627
Ratio of Estate Tax Liability to Asset Earnings	1.2

Source: Derived from applicable estate tax rates (Guide to Federal Estate Gift Taxation).

The typical firm in the $250,000 - $500,000 asset category has $359,031 in assets which would represent a $84,031 taxable estate with estate taxes due of $18,925 -- and an earning capacity of $18,627. The ratio of estate tax liability to asset earnings is 1.2%.

The estate tax burden and the liability of the heirs and the executor of the estate to pay this tax seriously threaten the continued existence of this firm.

Clearly, inflation and the rate structure of the estate tax have had a tremendous adverse impact over the years, but most specifically, this impact has been felt to a greater degree by the relatively small estate.

We have illustrated the tremendous tax liabilities which fall due upon the death of a principal owner of a small, closely held business. However, this problem is compounded when one considers the nature and liquidity of the assets which comprise the estate consisting mainly of an interest in a closely held business. Closely held stock is highly illiquid, as there is not a ready market for the stock and such stock is not easily salable. In addition, it is highly unlikely that a prospective buyer of closely held stock would be interested in obtaining only a minority interest in the firm, thereby allowing the heirs of the estate to continue control of the family interest in the business. One must also consider the tremendous problems encountered in valuation of the closely held stock, as there are no truly objective standards employed in the IRS valuation of the closely held stock for estate tax purposes.

The preceding discussion clearly demonstrates the problems which face the small, closely held business upon the death of a principal owner. The future of that business can be very directly affected by the ability of the heirs to pay the estate tax. Inability to generate a sufficient amount of cash to satisfy the estate tax liabilities may force the heirs to sell their interest in the closely held business for this purpose.

It must be understood that the closely held business which has lost its principal owner is already in a precarious position, notwithstanding the additional burden of estate taxes. A difficult transition period takes place, during which time the individual(s) charged with directing the business must seek to compensate for the loss of valuable management skill and leadership which the principal owner had furnished over the years. Customers and suppliers must be assured that the business will continue to provide goods and services in an efficient manner, that existing financial obligations will not be neglected for any reason, and that future profitability will not be adversely hampered.

The problems and concerns of the closely held business stated above are by no means all-inclusive. The fact remains that the closely held business will face a period of uncertainty and remain particularly vulnerable to a variety of situations when faced with the death of a principal owner, who was most likely the chief executive officer.

At the same time, however, the heirs of the business must also be concerned with the payment of estate taxes. When the estate consists largely of an interest in a closely held business, heirs have few options open to them with regard to payment of the estate tax: pay with cash on hand (usually not a viable option); pay with cash obtained through a loan; pay on an extended basis in yearly installments, or pay with cash obtained through sale or merger of the firm.

Extension of additional credit at this time is highly questionable. Indeed, the contrary is likely to happen as the principal owner is also the chief executive officer, the one looked to by the bank to manage the business in such a way that the bank will be repaid its already outstanding loans to the closely held business. When the closely held business loses its chief executive officer, the bank is very likely to recall a portion of the loan or decline to extend additional credit or renew current loans until the future of the business is more certain.

In this regard, NAW strongly supports legislative proposals now before this committee such as S. 1251, S. 1252 to deal with this problem.

In this regard, one must also consider the impact of Employee Stock Ownership Plans (ESOPs) on the ability of the closely held firm to elect to pay that portion of the decedent's estate tax attributable to the business interest in installments. The Congress has, on many occasions, endorsed the concept and utilization of ESOPs. However, if the closely held business determines that an ESOP should be established within that firm, the resulting increase in the closely held business's number of shareholders (and decrease in the percentage of voting stock held by the previous stockholders) could prohibit that firm from paying the tax in installments upon the death of a principal owner. The decision to establish an ESOP within a closely held business may therefore be tempered by considerations of the estate tax consequences.

The enactment of liberalized provisions for payment of estate taxes attributable to an interest in a closely held business would do much to enhance the perpetuation prospects of those businesses. Further, the revenue considerations involved in any liberalization of payment of these taxes would be small. Payment in full -- plus interest -- will be made; we are not advocating a forgiveness of any portion of the tax.

Unlimited Heirs Deduction

Additionally, we observe that current law provides for an unlimited estate tax marital deduction. NAW strongly endorses this concept and would go even further by recommending enactment of a separate unlimited children's deduction or expanding the marital deduction into an unlimited "family" deduction.

CONCLUSION

Mr. Chairman, in closing I wish to express again NAW's strong support for S. Res. 126 which opposes any repeal of or freeze on the estate tax reductions enacted in 1981, but which are not yet phased-in, and, in addition, legislation that would address the other substantive changes in the estate tax laws which I have outlined in my statement.

Without this estate tax relief for the small, family-owned wholesaler-distributors, the independent entrepreneur will slowly atrophy, and with that atrophy will go the unique characteristic that separates the American free enterprise system from any other economic system in the world.

Senator SYMMS. Thank you very much, Mr. Fitch, for your statement.

Next we will hear from Suzanne Nordblom.

STATEMENT OF SUZANNE NORDBLOM, NORDBLOM & ASSOCIATES, INC., LONG LAKE, MINN., ACCOMPANIED BY ROBERT R. STATHAM, GENERAL COUNSEL, NATIONAL FAMILY BUSINESS COUNCIL, INC.

Ms. NORDBLOM. Good morning. My name is Suzanne Nordblom and I am president of our family business, Nordblom & Associates, Inc., an architectural firm in Long Lake, Minn. I am also chairman of the Government Affairs Committee of the National Family Business Council [NFBC]. I am accompanied today by NFBC general counsel, Mr. Robert Statham of Washington, D.C.

The National Family Business Council is an association dedicated to the perpetuation of family business within our free enterprise system, and to maintaining a strong private sector in our economy. The NFBC represents the interests of over 10 million family businesses and well over 10 million American families. Not only are we the backbone of our American economy, but we also represent a vital component of the family structure in America.

On behalf of the NFBC, it is indeed my pleasure to express our appreciation for this opportunity to comment on the estate and gift tax issues as they have affected family businesses in the past, and specifically to endorse bills introduced by yourself and others that would amend the Internal Revenue Code of 1954 to repeal estate and gift taxes and to repeal the generation-skipping transfer tax.

The NFBC strongly urges the repeal of this generation-skipping transfer tax. The tax is a deterrent to the perpetuation of small and closely held businesses. The current law has been counterproductive due to its complexity, cost, and negative impact on capital retention.

The cost to the public, in both dollars and unproductive time spent deciphering the law, outweighs the minimal revenues generated by the tax. Smaller and medium-sized businesses are disproportionately affected, since the very wealthy often have methods available, such as separate trusts, with which to preserve capital.

A family-owned business typically must commit scarce and otherwise efficient resources to contend with the unnecessary complexities of the law. By taxing generation-skipping trusts and inhibiting the preservation of capital, this tax works against the stated economic goals of this Congress and administration.

In particular, this law has deterred many from using trusts as a tool to perpetuate family businesses. It is a drain on our economy and society, and it should be repealed.

The Congress must repeal the estate and gift taxes. Because of this tax, many family businesses will die after the first generation. In the past, the estate tax laws have caused heirs to liquidate the family business. Widows and children were oftentimes forced to sell the only property they owned in order to meet the tax bill.

The estate tax, which was enacted in 1916, was never intended to discourage or to prevent the perpetuation of family-owned businesses. As you commented in your opening statement, Mr. Chairman, the various provisions of the Federal estate and gift tax laws produce complexities in the estate planning; encourages disposition of assets contrary to the best interests of taxpayers, beneficiaries and the economy; and it works gross inequities among taxpayers.

We do not take issue with the fundamental purpose of the estate and gift tax laws. We are by no means opposed to paying our fair share of taxes, but during the past 60 years, changes in our society and economy have resulted in altering the effect of this legislation, causing hardship for the transfer of the family business within one's family.

Although much progress has been made in the past few years to ease the burden of the tax, it still penalizes the heirs of those who took the risks of being in business for themselves, working throughout their lives to become profitable and to pass their accomplishments on to future generations.

The right of succession and the right to dispose of ones property as one chooses are freedoms which cannot be limited by our Government. By limiting these freedoms, the Government is smothering the fundamental principles that built our country. Our ancestors came to this country seeking such rights as property ownership and succession. Seeking such rights that were denied them by their governments, for they truly believed that no government should deny a man of these freedoms.

Family-owned businesses are a integral and vital component of our economy and society. As a source of entrepreneurial spirit, and for their many contributions in the fields of technology and innovation, family-owned businesses must be preserved and protected.

Again, I appreciate this opportunity to be here today to express the views of the National Family Business Council, and may I offer to you the services and cooperation of our organization. Thank you.

[The statement of Ms. Nordblom follows:]

STATEMENT OF SUZANNE L. NORDBLOM ON BEHALF OF NATIONAL FAMILY BUSINESS COUNCIL BEFORE THE SENATE FINANCE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION HOLDING HEARINGS ON THE ESTATE TAX ISSUES, JUNE 27, 1983

My name is Suzanne L. Nordblom. I am president of our family business, Nordblom and Associates, Inc., an architectural firm in Long Lake, Minnesota. I am also chairman of the Government Affairs Committee of the National Family Business Council (N.F.B.C.). I am accompanied today by the N.F.B.C. Senior Advisory Committee member Stevan A. Wolf, general manager of his family business, Penbrook Confections, Inc., of Westville, New Jersey, and by the N.F.B.C. General Counsel, Robert R. Statham of Washington D.C.

The National Family Business Council is an association dedicated to the perpetuation of famiy business within our free enterprise system, and also, to maintaining a strong private sector in our economy by promoting the free enterprise system and true capitalism in our democracy. Membership in the National Family Business Council is composed of individuals, firms and corporations engaged in family businesses, and those interested in the well being and perpetuation of family-owned enterprises.

The N.F.B.C. represents over ten million Family Businesses and well over ten million American Families. Not only are we the backbone of our American economy, but we also represent a vital component of the Family structure in America. We are not a trade association or a special interest group; nor are we professional lobbyists. Our goal is survival of the Family Business Enterprise in our American economy and society.

On behalf of the N.F.B.C., it is indeed my pleasure to express our appreciation for this opportunity to speak to you about the Estate and Gift Tax, and the Generation-Skipping Transfer Tax.

GENERATION-SKIPPING TRANSFER TAX

Many small business owners work hard to build their businesses for their children, and by creating an easier method by which to transfer ownership, there will be future generations to maintain these family businesses. The N.F.B.C., therefore, strongly urges the repeal of the Generation-Skipping Transfer Tax.

This tax is a deterrent to the perpetuation of small and closely-held businesses. The current law has been counter-productive due to its complexity, cost, and negative impact on capital retention.

The cost to the public in both dollars and unproductive time spent deciphering the law outweighs the minimal revenues generated by the tax. Current revenue projections indicate that the Generation-Skipping Transfer Tax raises no monies in the short run and is projected to raise only $400 million in the year 2001. However, the negative impact and the costs of the tax to the economy in lost productivity are current and ongoing.

Smaller and medium size businesses are disproportionately affected, since the very wealthy often have methods available, such as separate trusts, with which to preserve capital. A family-owned business typically must commit scarce and otherwise efficient resources to contend with the unnecessary complexities of the law.

The stated intention of taxing property as though it had been transferred outright has not been achieved. The law attempts to presuppose the sequencing of generations and, in doing so, compounds the confusion. Distrust and misunderstanding of the law has resulted in individuals not properly using trusts to protect their families from uncertain and most likely inflationary futures.

By taxing generation-skipping trusts and inhibiting the preservation of capital, Chapter 13 of the Internal Revenue Code of 1954 works against the stated economic goals of this Congress and Administration. In particular, this law has deterred many from using trusts as a tool to perpetuate family businesses. Chapter 13 is a drain on our economy and society and should be repealed.

NEED FOR LIQUIDITY

Even though there are numerous ways to plan effectively for the transfer of ownership, the process of estate planning takes valuable time and money away from constructive uses, thus stifling productivity, ingenuity and technological improvements. Financing the transfer of the ownership within the family then becomes a critical challenge. Inheritance taxes on business assets, multiplied by the effect of inflation, are so high as to drain funds from working capital, and this, coupled with the enormously complex task of estate valuation, forces the entrepreneur to think of retention before growth.

ESTATE AND GIFT TAX

The 98th Congress must repeal the Estate and Gift Tax. Because of this tax many Family Businesses will die after the first generation. Existing estate tax laws frequently cause heirs to liquidate the family business or to sell the business to a larger, usually public, concern. Widows and children are often times forced to sell the only property they own in order to meet the tax bill.

Inflation has pushed family businesses that were too small to pay estate taxes into extremely high tax brackets. The result has been that heirs of these enterprises have been forced out of business in order to pay stiff Federal estate taxes.

Inflation and the increase of economic concentration through conglomerate mergers has seriously imperiled the maintenance of family farms and businesses of all kinds. Our existing tax structure has the effect of subsidizing the growth of big business usually at the expense of small and independent enterprise. Present tax laws encourage those who own an interest in small business to sell out to large companies because the acquiring company may exchange its stock for the stock of the small business. The entire transaction is tax free. What we are witnessing today is a major threat to the very survival of our free and independent enterprise system.

The estate tax which was enacted in 1916 was never intended to discourage or prevent the perpetuation of the family owned business. Todays' estate tax preys on the widows and children of those whose lifetime efforts have gone into the building of family enterprises.

It is evident today even after the passage of the 1981 Tax Act, that the fundamental purposes of the estate and gift tax laws are not being fulfilled. Estate and gift tax laws were never intended primarily to produce revenue, and this is in fact the case today since less than 1 percent of total revenues collected are derived from the estate and gift taxes.

The various provisions of the Federal estate and gift tax laws produce complexities in the estate planning; encourage disposition of assets contrary to the best interests of taxpayers, beneficiaries, and the economy; and work gross inequities among taxpayers.

The fundamental purpose of the estate and gift tax laws were to tax the very wealthy, very heavily, to limit undue concentrations of wealth and power in a few, to break up those concentrations, and to enhance the equalitiy of opportunity. This is a principle with which we do not take issue. We are by no means opposed to paying our fair share of taxes. In fact, the record will show that privately held firms have always paid a higher percentage of their profits in taxes than have the giant corporations and conglomerates. During the past sixty years, however, changes in our society and economy have resulted in altering the effect of this legislation, causing hardship for the transfer of the Family Business within one's family.

While the Congress made significant gains in reducing the onerous burden of estate and gift taxes in the 1981 Economic Recovery Tax Act, we shall continue to strive for total elimination of the "death tax."

Family-owned businesses are an integral and vital component of our economy and society. As a source of entrepreneurial spirit and for their many contributions in the fields of technology, innovation and social advancement, family-owned small businesses must be preserved and protected. The family business is a source of pride which gives the family a personal sense of freedom, accomplishment and pride in ownership. The perpetuation of the family business in America is of significant importance to the survival of free enterprise that has built the foundation of our country and economy.

I appreciate this opportunity to be here today to express the views of the National Family Business Council on the need for changes in the estate and gift tax and the generation-skipping tax. May I offer you the services and cooperation of our organization to assist you in any way possible in your efforts with regard to estate and gift taxation.

Senator SYMMS. Thank you very much for a very excellent statement, which I happen to agree with.

I might just ask a question. Are you an architect?

Ms. NORDBLOM. Yes, I am.

Senator SYMMS. How many people do you employ in your firm?

Ms. NORDBLOM. The state of the economy right now does not permit many architectural firms to employ as many people as they have in the past. Right now we have three in our firm. This has come about in the past 2 or 3 years. Up until that time we employed up to 10.

Senator SYMMS. The reason I make that point for our record is, as I said earlier when Mr. Fitch testified, oftentimes people just take it for granted that the interest for the repeal of the death tax comes only from the farms and ranches and property where there are big land tracts involved, but it surprises many people to find that it has just as detrimental an effect on many other small businesses. And here is a professional architecture firm that is affected by this. We have wholesaler-distributors.

Senator Boren has certainly articulated the case over the years that he has been here in the Senate about the newspapers and how we have watched the gravitation of newspapers fall into the hands of big newspaper chains because of the death taxes. In your case it would be the big architect firms that gradually take up the small ones.

So really the opposite effect of what some people think the impact might be on the economy. If we want to promote small business and entrepreneurial activity and innovation and private property, then the estate tax truly is a roadblock for those people who are trying to look forward to upward mobility and start a business and be able to pass it on.

And I think we have a good example here, just in the fact that we have a professional architect in here this morning who normally, people wouldn't think that they would be impacted by this, but surely they are and we have wholesaler-distributors affected. We appreciate very much your testimony.

Now we want to hear from Mr. Wolf, chairman of the legislative policy committee of the National Small Business Association.

STATEMENT OF STEVAN A. WOLF, CHAIRMAN, LEGISLATIVE AND POLICY COMMITTEE, NATIONAL SMALL BUSINESS ASSOCIATION

Mr. WOLF. Good morning. My name is Stevan Wolf. I am the general manager of our third generation candy manufacturing business, Penbrook Confections, in Westville, N.J.

As you mentioned, I am also chairman of the legislative policy committee of the National Small Business Association, a 46-year-old national organization with approximately 50,000 members. We have been in the forefront of efforts to revise and reform the estate tax since 1973 and are pleased to join with all concerned in advancing the cause of preserving the gains achieved in the Economic Recovery Tax Act of 1981.

As I was sitting here listening to much of the testimony, the Treasury in particular struck my fancy because as complicated and as confusing as it is for us, I wonder if they really recognize the problems that we have to face when trying to solve these problems, in addition to running our businesses. For that reason, the law has to be simplified and clarified, just to help us so we know which direction we are going.

In 1980, the White House Conference on Small Business found the estate tax reform to be the fourth most important issue to the small businessman. Congress and the President addressed this problem in 1981 and created a temporary, but effective solution. Now that the Government has some budgetary problems it is felt in some quarters that freezing the estate tax reductions will help ease their burden.

Inflation still exists. Our property values are still increasing and will increase more. We in the small business community do not see the need to take three giant steps backward for what little you would gain.

The estate tax now represents a little bit less than 1 percent—and it used to represent around 2 percent and it is shrinking—of the budget, and probably costs the Government about half that just to collect. It really seems to cause more problems than it is worth. Besides, it is very discouraging, as you have mentioned, for the private sector.

Not only should the estate and gift tax reform in ERTA remain; more still needs to be done. In 1987 we must again review where we are in regard to inflation and again adjust our exclusions and our tax rate.

Also, let us suggest some further reforms, if not repeal in its entirety. No. 1, as mentioned by Mr. Fitch here, the separation of the family farm or family business from the personal estate I think could be very excellent when a qualified heir is available and working within the business or on the farm. He could then pass the business tax free to this qualified heir instead of to the spouse, who most likely is not involved with the day-to-day operations of the business.

This would give the next generation of entrepreneurs the encouragement to carry on toward the American dream that we have. We must spend our time creating profit, jobs and growth for the country, rather than spending hours each year with our insurance agents and lawyers changing our wills and insurance policies.

Right now I have a son who is 6 years old. At this age, I have the opportunity to influence him to come into the family business or seek another career somewhere outside the business. Professional sports teams are a big thing right now. I can't begin to tell you how encouraging it has been for me to sit here and listen to you and the other members of the committee talk about the importance of repealing the estate tax law and giving us the opportunity to fulfill the American dream. It is something that I can and will pass on to my son. It is very, very helpful and this is the encouragement that we need so that more young people can get involved.

In our view, the 1981 revisions provide a convincing statement of the rationale for an estate tax law that facilitates small business continuity. The Senate Finance Committee has done a great job and a great deal of work in the past Congresses to produce a far-reaching revision proposal. The extensive public hearings by former Senator Byrd of Virginia and former Senator Nelson of

Wisconsin and now you, Senator Symms and your other Finance Committee members, have established a solid record on which to base meaningful legislation.

As a result, we have seen a wide bipartisan support in Congress for the measures enacted. We believe this was backed up by broad support among the business community and the public. We commend the Finance Committee for these successful initiatives and strongly support Senate Resolution 126, which would assure the full scope and intent of the ERTA Act of 1981 to be carried out.

In the short run and even more important over the long run, we believe such a policy would have the most desirable effects for the country's business, economic, and social landscape, and our next generation, my kids.

Thank you very much for this opportunity.

[The statement of Mr. Wolf follows:]

STATEMENT OF STEVAN WOLF ON BEHALF OF THE NATIONAL SMALL BUSINESS ASSOCIATION BEFORE THE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION OF THE SENATE FINANCE COMMITTEE HOLDING HEARINGS ON ESTATE TAX ISSUES

June 27, 1983

Good Morning. I am Stevan Wolf, General Manager of my family-owned business, Penbrook Confections in Westville, N.J. I am also Chairman of the Legislative Policy Committee of the National Small Business Association (NSB), a 46 year old national organization with approximately 50,000 members. We have been in the forefront of efforts to revise and reform the estate tax since 1973, and are pleased to join with all concerned in advancing the cause of preserving the gains achieved in the Economic Recovery Tax Act of 1981.

Several years ago, an economist observed that if an airplane passed over the country-side of any nation, the passengers could tell what the estate tax laws were. In France, he said, small plots of ground were tightly bound by fences and hedgerows. There, all heirs inherited equally. In England, there were larger farms and occasional estates, a consequence of centuries of primogeniture.

Our own country is now at a juncture of tax policy which will shape the contours of the American economic and social structures for many years to come. We have been brought to this decision by a historic surge of inflation, which has sent the general price level up close to 100 percent in the past 12 years. The Economic Recovery Tax Act of 1981 raised the federal estate exclusion in stages to $600,000 effective in 1987 and lowered the rate to 50%.

During this same period, owners of farms and small businesses have witnessed a climb in the values of land and capital equipment of well over 100 percent, that is even steeper than the averages, as shown in the following table:

CHANGES IN PRICE LEVELS

	1971	1976	1980	10-yr. increase
Inflation (GNP deflator)*	96.01	132.11	177.36	+ 84.73%
Capital Equipment**	116.6	173.4	239.8	+105.66%
Farm Land***	$223.2 bil.	$416.9 bil.	$671.2 bil.	+200.72%
Producer Prices**	113.7	170.6	247.0	+117.24%

*Expressed in terms price level in 1972 (e.g. 1972 = 100)
**1967 = 100
***Nominal dollars
Source: Economic Indicators, JEC-CEA, 1979-81.

Accordingly, inflation alone justified a sizable increase in the fixed dollar limitations of the estate and gift tax, merely in order to restore the original Congressional intent of the 1976 reform legislation.

We are gratified that both the Congress and the President recognized the seriousness of the problem, and provided appropriate remedies.

Such a response was minimal, and we fully support the efforts of Senators Symms, Boren and others to repeal the estate and gift taxes for family businesses.

SPECIAL PROBLEMS OF FAMILY AND CLOSELY-HELD ENTERPRISES

For the owner of a farm or business, the aggravated inflation of business assets over long periods of time makes the need for constant estate tax revision absolutely essential.

Let us look at an actual example which was used in our testimony just two years ago. One of our members is a small manufacturer of industrial machinery here in the East.

Begun by his grandfather, the firm is over 100 years old. It employs 30 workers, some of whom are second generation employees. It owns an 80 foot by 250 foot building, constructed in 1955, sitting on 3 1/2 acres of land, and containing the appropriate machine tools, The balance sheet looks approximately as follows:

BALANCE SHEET OF SMALL MANUFACTURER

	Cost	Book Value	Approximate Market Value
Building	$225,000	$100,000	$ 500,000
Land	5,000	5,000	150,000
Machinery		70,000	350,000
Total		$175,000	$1,000,000

The family circumstances -- a wife who is not a businesswoman, a daughter in the computer field, and a son studying for the ministry -- indicate that this firm must be sold either to employees or an outside purchaser.

At present, it is improbable that the 5 key employees would, even together, have enough personal net worth to buy the owner out, or under existing estate tax limitations, to continue the business after his death. Using relatively conventional assumptions, this small business estate might be liable for approximately $140,000 in federal estate taxes, plus state inheritance taxes. In addition, if the employer had provided a pension plan for his employees that has an unfunded liability, the government, through the Pension Benefit Guaranty Corporation, can receive up to 30 percent of the assets of the company for the unfunded liability of the pension plan. In the case of most small employers, the unfunded liability may be substantial. That means, in all likelihood, that this company would have to be closed, sold, or merged into a larger business, if the 1981 exclusions were to be repealed or frozen at 1983 levels.

Traditionally, a primary purpose of the estate tax is to discourage the concentration of wealth. These kinds of pressures are now promoting the concentration of wealth. Other members have informed the association that an owner may be paying 25 percent of his income in insurance premiums in order to provide for estate tax payments so a business may be continued.

Everyone who has studied this area has commented on the complexity of arrangements needed to have any chance of continuing a family or closely-held firm after an owner's death. The uncertainty of the valuation of a non-public firm -- which can literally take years of negotiation and/or litigation--is a major deterrent to even attempting to run the gauntlet of the tax collectors.

A member of the Finance Committee (Senator Bentsen) has written: "In my view it is not the government's place to tax away a lifetime of hard work and thrift when a family member dies."

Unfortunately, that is exactly where the estate tax policy--under the impact of inflation--was headed, prior to the 1981 enactment. We deeply believe that we need estate tax standards that encourage continuity rather than discourage small business ownership. Small enterprise is the dynamic mainspring of the U.S. economy. Government statistics show that:

° Small firms sustain 55 percent of existing private sector jobs, and create a striking percentage of net new employment -- President Reagan says 80 percent;

° They are an equal partner in generating our traditional Yankee ingenuity, accounting for half of all innovation in heavy industry, light industry, trade and commerce. Examples of recent small business innovations that have sparked impressive advances in employment, exports and tax revenues include the xerox process, air conditioning, the instant camera and miniature electronics.

° They make major financial contributions to all levels of government. For example, a 1978 survey showed that $100 invested in the electronic industry yielded $35 per year in federal, state, and local taxes.

° Small business owners are major factors in the stability of their towns and cities. They know their employees and customers. As President Reagan's recent report on small business shows, they are the last to fire people when the economy turns down and the first to hire employees as it revives. The owners have a stake in their hometowns, so they and their families often work to support churches, synagogues, charities and other neighborhood and community institutions.

° Small business has always been the doorway of opportunity into the mainstream of our economy, and the means for self-reliance and independence for millions of our citizens.

In our view, the 1981 revisions provided a convincing statement of the rationale for an estate tax law that facilitates small business continuity.

The Senate Finance Committee has done a great deal of work in the past Congresses to produce a far-reaching revision proposal. The extensive public hearings by former Senator Byrd of Virginia, former Senator Nelson and Senator Symms established a solid record on which to base meaningful legislation. As a result we have seen wide bi-partisan support in the Congress for the measures enacted, we believe this was backed up by broad support among the business community and the public.

When Senator Wallop originally introduced S. 395, he remarked to the Senate:

> "The legislation focuses on relieving the harsh consequences of inflation, especially as it interacts with the estate tax laws to force many family-owned firms and small enterprises out of business." 1/

We commend the Finance Committee for these successful initiatives, and strongly support S.Res. 126 which would assure that the full scope and intent of the Economic Recovery Tax Act of 1981 be carried out. In the short-run, and even more over the long-run, we believe that such a policy will have the most desirable effects on the country's business, economic and social landscape.

In conclusion, small business appreciates the opportunity the Committee has given us to be heard on this matter. We are pleased that you have allowed us to present our views and look to your continued interest on this important issue.

1/ Congressional Record, February 5, 1981, Pages S.1023-1030.

# # #

Senator SYMMS. Thank you very much, Mr. Wolf. Now you are in the candy manufacturing business?

Mr. WOLF. Yes.

Senator SYMMS. How many people do you employ?

Mr. WOLF. We currently employ 55 and over the next 6 months we will run up to about 120 when we make candy canes, which is obviously very seasonal, so it will increase.

Senator SYMMS. So of course when something happens where a great deal of capital is taken out of a business, it actually has a negative impact on employment, jobs.

And I think this is one reason why this issue has so much appeal. Many of the people in the country who work for small businesses are very happy to work in a more personalized situation than working for a bigger company, and they more and more are becoming aware of the impact of the death tax, if it forces the liquidation of the business, that it may end meaning that some of those people will then be working for larger companies and maybe in a less personal working relationship with the management than they do have presently.

I think that that is just another good reason why this tax is not a good tax.

And another reason, when one looks at the size of the deficits, that is, of the amount of money that Congress borrows or prints to cover the difference between the revenue that comes in and how much the Congress spends, it is really a drop in the bucket. It would be much more sensible, I think, to have some form of tax based on consumption, rather than a tax based on basic production.

This is truly a tax right at the heart of production, an estate tax. It really cuts the muscle and bones right out from under the ability of small business to expand and capitalize their businesses the way they should.

I have recently witnessed a small-family business in my State where decisions are being made that weaken the family company strictly because of the concern of buying everything twice that the company buys.

So instead of directly purchasing land or equipment that is necessary to operate the business, there are always decisions being made to do it in some form of buying it outside, leasing it back to the company, keeping the assets out of the corporation, which actually may need it for the long-term solvency for the benefit of the employees that work there, so that in hard times, that they will actually have the credit and the capital to do business.

But decisions are made every day that are detrimental to production in this country because of this tax, which is pure socialism in its inception and it is antigood judgment, anticapitalism, antiprivate property in terms of having a fair base for which those businessmen, the individuals in this country can make sound decisions based on what is good for the country what is good for their business. Usually will end up that if you can run your business in a proper fashion and make a profit, the fringe benefit of that has a benefit for all people in the community.

I thank all of you for being here and contributing to our hearing record, and I think that these statements will be very helpful to our hearing. I would say again, just to remind our reporter, that all of these statements will be inserted in their entirety to our record. Thank you very much.

Our next panel will be Edward Delaney, Billy R. Carter, and Robert Barkley.

Mr. Delaney, nice to have you before the committee again this morning and please proceed.

STATEMENT OF EDWARD N. DELANEY, ESQ., CHAIRMAN-ELECT, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, ACCOMPANIED BY JOHN JONES, VICE PRESIDENT FOR GOVERNMENT RELATIONS

Mr. **Delaney**. Thank you, Senator. I am Edward Delaney and I appear today as chairman-elect of the tax section of the American Bar Association. I am accompanied by John Jones, our vice chairman, government relations.

I am going to limit my comments to S. 1251 and S. 1180 With respect to S. 1251, my comments represent only the views of the tax section and should not be construed as representing the position of the American bar.

The section has had a continuing interest in deferred payment of estate taxes, and statements on the issue were submitted to this subcommittee on December 17, 1981 and again on May 27, 1982. These statements recommended improvements to section 6166 and related sections of the Internal Revenue Code.

Many of the recommendations which the section submitted have been incorporated in S. 1251, and of course those, we support. There are, however, technical differences between our recommendations and the provisions of S. 1251.

One of the concerns we have with S. 1251 is the extreme length and complexity of the bill. We believe that in several areas, the common objective of improved effectiveness of the estate tax deferral option can best be served by simplifying present law, rather than by making it more complex.

One section recommendation is that the various mechanical tests for determining when a closely held business interest exists, including the complex attribution rules, be eliminated and replaced by an exclusive nonmarketability test such as that now found in section 6166(b)(7), which is applicable to nonreadily tradeable stock. Under such a test, stock or partnership interest would qualify if, at the time of the decedent's death, there was no market on a stock exchange or in the over-the-counter market for such stock or partnership interest. Proprietorship interest would automatically qualify, as under present law. Such a test would be simple to apply and simple for taxpayers to understand.

Importantly, pages 2 through 11 of the printed text of S. 1251, pages which contain extremely complex attribution and other definitional rules, could be eliminated.

The section approach would promote fairness in that an interest in a publicly traded corporation in which the decedent and members of the family owned 20 percent or more could not qualify as a closely held business interest as to which deferral would be permitted, whereas qualification under these circumstances would continue to be possible under S. 1251 as drafted.

S. 1251 would permit notes to qualify as closely held business interests under certain conditions, as well as overriding royalty interests and assets leased to closely held businesses.

Although an argument can be made for extending the closely held business interest definition to such assets, the administrative problems that will likely flow from such an extension, particularly in the acceleration area, appear formidable.

If the nonmarketability test proposed by the section were adopted, it would probably be desirable from an administrative standpoint to continue to require that a closely held business interest have some minimum value to be aggregated with other business interests to reach the 35-percent adjusted gross estate threshold.

There would not appear to be any substantial administrative or fairness problems involved in using the test proposed in the current draft of S. 1251, which requires only that each closely held business interest represent 5 percent or more of the adjusted gross estate. S. 1251 also permits certain smaller business interests to be aggregated. This may create administrative problems.

The section recommendation to solving the repetitive calculations required under present law to deal with interest on deferred estate tax payments where such interest is claimed as an estate tax deduction is to disallow interest as an estate tax deduction, and in return, establish a uniform interest rate on the deferred payments equal to one-half of the rate on tax deficiencies generally.

Arguments could be made for an even lower interest rate, since Congress has always maintained a lower interest rate on deferred estate tax payments than on tax deficiencies generally. The question of the precise level of the interest rate is one which Congress is best able to decide. Nevertheless, the section believes that the principle of a substantially lower rate should follow from eliminating interest on the deferred payments of estate tax as a deduction.

We have several other technical amendments and improvements that we believe are important and should be taken cognizance of.

I would like briefly to talk about S. 1180 and here we speak on behalf of the Bar Association in general. The tax section has considered the issue covered by S. 1180 and concluded that as a matter of policy, an effective disclaimer should be allowed in the case of any future interest in property not later than 9 months after the event when the taker of the interest is finally ascertained and his interest has become indefeasible. That position was endorsed by the American Bar Association.

Rather than the more narrowly directed provisions of S. 1180, we urge the adoption of a rule which reverses the Supreme Court decision that you have heard about, the *Jewett* case, and permits the holder of future interest to disclaim within 9 months after the interest has become indefeasible.

Thank you.

[The statement of Mr. Delaney follows:]

STATEMENT OF
Edward N. Delaney
Chairman Elect
Section of Taxation
American Bar Association

before the

Subcommittee on Estate and Gift Taxation
Senate Finance Committee

June 27, 1983

RE: S. 1251 -- To treat certain interests as closely held businesses for estate tax purposes, and to prevent the acceleration of estate tax installment payments in certain situations

S. 1180 -- To provide transitional rules for estate and gift tax treatment of disclaimers created before November 15, 1958

My name is Edward N. Delaney. I am Chairman-Elect of the Section of Taxation of the American Bar Association. In that capacity, I am pleased to express the views of the Section of Taxation with regard to S. 1251, and the views of the American Bar Association with regard to S. 1180.

I. S. 1251 - Closely Held Businesses and Deferred Payment of Estate Taxes

My comments with respect to S. 1251 represent only the views of the Section, and should not be construed as representing the position of the Association. The Tax Section has had a continuing interest in deferred payment of estate taxes. Statements on the issue were submitted to this Subcommittee on December 17, 1981 and again on May 27, 1982. Those statements recommended improvements to section 6166 and related Sections of the Internal Revenue Code. In April of this year the Treasury Department stated its position with respect to S. 2479 (97th Congress), the predecessor of S. 1251.

Many of the recommendations which the Section of Taxation previously submitted have been incorporated in S. 1251. There are, however, technical differences between our recommendations and the provisions of S. 1251. We believe it may be helpful to outline the major areas where substantive changes are suggested by both the Tax Section and S. 1251 and also to describe where differences in approach exist. One of the concerns which the Section of Taxation has with S. 1251 is the extreme length and complexity of the bill. We believe that in several areas the common objective of improved effectiveness of the estate tax deferral option can best be served by simplifying present law rather than by making it more complex.

Definition of "Interest in a Closely Held Business"

The Tax Section recommendation is that the various mechanical tests for determining when a "closely held business interest" exists, including the complex attribution rules related thereto, be eliminated and replaced by an exclusive nonmarketability test such as that now found in §6166(b)(7) of the Code applicable to non-readily-tradable stock. Under such a test, stock or partnership interests would qualify if, at the time of the decedent's death, there was no market on a stock exchange or in an over-the-counter market for such stock or partnership interest. Proprietorship interests would automatically qualify as under present law. It is believed that such a test would be simple to apply and simple for taxpayers to understand. Under that approach, we believe that pages 2 through 11 of the printed text of S. 1251, pages which contain extremely complex attribution and other definitional rules, could be eliminated. In addition, the Tax Section approach would promote fairness in that an interest in a publicly traded corporation in which the decedent and members of his family owned 20% or more could not qualify as a closely held business interest as to which deferral would be permitted, whereas qualification under those circumstances would continue to be possible under S. 1251 as drafted

S. 1251 would permit notes to qualify as closely held business interests under certain conditions, as well as overriding royalty interests and assets leased to closely held businesses. Although an argument can be made for extending the closely held business interest definition to such assets, the administrative problems that will likely flow from such an extension, particularly in the acceleration area appear formidable.

Aggregation of Closely Held Business Interests

Where a decedent's estate owns an interest in two or more closely held businesses the question arises whether and under what conditions these business interests may be aggregated in order to reach the 35% of adjusted gross estate threshold to qualify the estate for deferral treatment. After ERTA the rule is that the decedent's estate must own 20% or more of the value of each of such closely held business interest in order to permit them to be aggregated.

If the nonmarketability test proposed by the Tax Section were adopted, it would probably be desirable from an administrative standpoint to continue to require that a closely held business interest have some minimum value to be aggregated with other business interests to reach the 35% adjusted gross estate threshold. This would prevent the aggregation of numerous small interests, such as those which the decedent might hold in various tax shelter partnerships. There would not appear to be any substantial administrative or fairness problem involved in using the test proposed in the current draft of S. 1251, which requires only that each closely held business interest represent 5% or more of the adjusted gross estate. S. 1251 also permits certain smaller business interests to be aggregated. This also may create administrative problems.

Interest on Unpaid Installments

The Tax Section recommendation to solving the repetitive calculations required under present law to deal with interest on deferred estate tax payments where such interest is claimed as an estate tax deduction is to disallow the interest as an estate tax deduction, and in return establish a uniform interest rate on the deferred installments equal to one-half of the rate on tax deficiencies generally, this rate was suggested because at the 50% estate tax bracket the Section's proposal produces the same revenue without the complex calculations. Arguments could be made for an even lower interest rate since Congress has always maintained a lower interest rate on deferred estate tax payments than on tax deficiencies generally. Furthermore, if the 4% rate portion which is allowable under present law were eliminated, this should equitably be translated into a lower overall rate. The question of the precise level of the interest rate is one which Congress is best able to decide, Nevertheless, the Tax Section believes that the principle of a substantially lower rate should follow from eliminating interest on deferred payments as an estate deduction. This, we submit, is a sound principle which promotes fairness as well as simplification.

S. 1251 adopts an alternative approach to this problem, permitting an "up front" deduction based on the estimated interest expense which the estate might be expected to pay over the entire deferral period. This amount would be adjusted based on rules promulgated by Treasury Regulations. That procedure is substantially more complex than the Tax Section proposal, and may, indeed, be no less complex to use than the present rules. The S. 1251 approach will require adjustments to account for the difference between actual interest expense and estimated interest expense, even without acceleration events, which would require still further adjustments.

Acceleration of Payment of Deferred Taxes

One of the major technical problem areas in estate tax deferral is the termination of the deferral privilege ("acceleration"). ERTA improved and simplified the acceleration provisions somewhat, but the Tax Section believes that further improvements are necessary.

One area in which improvement is necessary is the redemption of stock or partnership interests from the estate in exchange for notes of a closely held business. The Tax Section recommends treating the obligations so exchanged as a substitute for the closely held business interest, so that an acceleration event would not occur at the time of the exchange, while a subsequent disposition of the obligations might trigger acceleration. S. 1251 sets forth extremely detailed statutory rules to deal with this problem, covering some 15 pages of printed text relating to §6166, and a similar number of pages relating to §6166A (for decedents dying before January 1, 1982 with respect to dispositions taking place after December 31, 1981). The Tax Section believes that the simpler statutory approach embodied in its legislative recommendation will better serve the administration of the tax laws even though it is somewhat less comprehensive in scope.

Another acceleration problem area where improvements were recommended by the Tax Section involves interaction with §303. Present law does not protect §303 redemption proceeds which are used to pay interest on deferred taxes and/or administration expenses. S. 1251 accomplishes this purpose, and also adopts the Tax Section recommendation that a disposition or withdrawal exists only with respect to the excess of the amount of the §303 redemption over the amount used to pay taxes interest and administration expenses. The bill also adds clarity to present law regarding the time when estate taxes and interest must be paid in coordination with §303 redemptions, and contains provisions designed to accord partnerships and proprietorships relief from the operation of the acceleration provisions similar to that now available under §303 to corporate redemptions.

S. 1251 contains other provisions designed to foreclose accelerations where no substantial change in the character of the closely held business interest has taken place. These appear to be equitable provisions which should not create administrative complexities.

Judicial Resolution of §6166 Controversies

The Tax Section in its prior submission pointed out the need for a judicial forum to test §6166 qualification questions, as well as acceleration questions. S. 1251 addresses this problem by providing for a special Tax Court declaratory judgment procedure. The Tax Section recommendation was to treat §6166 qualification issues procedurally in the same manner that tax liability questions would be treated. Under that procedure, a personal representative who believes the estate is entitled to qualify under §6166 would take that position on the estate tax return; and, if the examining Revenue Agent should disagree, the matter would be dealt with via the normal administrative, and, if necessary, judicial channels, in the same manner as any other estate tax deficiency issue.

The Tax Section proposal has the advantage of simplicity in that it builds upon the existing administrative and judicial structure, and avoids multiplicity of litigation. Under the Tax Court declaratory judgment procedure, on the other hand, irrespective of the resolution of the declaratory judgment question, the same estate may once again be in litigation on another issue, such as valuation. There is efficiency in litigating the deferral qualification question at the same time that estate tax liability questions are being litigated. We are pleased that the Treasury Department, in its April statement, has dropped its opposition to judicial review of section 6166 controversies.

Retroactivity Issue

As drafted, provisions of S. 1251 have application to the estates of decedents dying before January 1, 1982. The proposed acceleration rules would apply to determine whether post-1981 transactions involving estates of pre-1982 decedents constitute dispositions or withdrawals. Likewise, the judicial forum provisions of S. 1251 would be made applicable to acceleration questions arising from post-1981 transactions in the case of pre-1982 decedents. Furthermore, under S. 1251 estates of decedents dying before 1982 would be entitled to elect to deduct interest under the proposed new rule. The only estate tax provision of ERTA in this area affecting decedents dying before January 1, 1982, is the provision preventing acceleration upon the death of a transferee family member after December 31, 1981. The Tax Section does not generally favor retroactive provisions. Generally estate tax effective dates are keyed to the date of the decedent's death.

II. S. 1180 - Transitional Rules for Disclaimer of Future Interests

I also wish to comment with respect to S. 1180, and here I speak on behalf of the American Bar Association. S. 1180 provides a 90-day period for persons who hold a future interest in property created under a pre-November 15, 1958 instrument to disclaim that interest without gift tax consequences. The bill is designed generally to apply to a narrow group of individuals.

The Tax Section considered this issue and concluded that as a matter of policy an effective disclaimer should be allowed:

> "in the case of any future interest in property not later than nine months after the event when the taker of the interest is finally ascertained and his interest has become indefeasible."

That position was endorsed by the American Bar Association in 1975. We refer the Subcommittee's staff to Tax Section Recommendation Number 1974-2, which appears at 27 Tax Lawyer, page 818. Rather than the narrowly directed provisions of S. 1180, we urge adoption of a rule which reverses the Supreme Court in the recently-decided Jewett case and permits the holder of a future interest to disclaim within nine months after the interest has become indefeasible. By definition, to constitute a qualified disclaimer the disclaimant may have not received actual benefits from the disclaimed property. Facing the issue in this manner is entirely consistent with Section 2518 introduced by the 1976 Tax Act, as subsequently amended.

Senator SYMMS. Thank you very much for a very excellent statement. I appreciate having that for our record.

Next we will hear from Mr. Billy R. Carter, Associated General Contractors of America.

STATEMENT OF BILLY R. CARTER, CHAIRMAN, TAX AND FISCAL AFFAIRS COMMITTEE, ASSOCIATED GENERAL CONTRACTORS OF AMERICA

Mr. CARTER. Thank you, Mr. Chairman. My name is Billy R. Carter I am the vice president of Nello L. Teer Co. in Durham, N.C. I am testifying for the Associated General Contractors of America, as chairman of the association's tax and fiscal affairs committee.

The Associated General Contractors of America, AGC, represents more than 32,000 firms, including 8,500 of America's leading general contracting companies, which are responsible for the employment of more than 3.4 million individuals. These member contractors perform more than 80 percent of America's contract construction of commercial buildings, highways, industrial and municipal utility facilities.

AGC's principal concern with estate taxes is to ease the burden of transferring a closely held business following the death of a controlling principal. The construction industry is characterized by thousands of small firms which are highly competitive. These firms are often family-owned and operated.

The imposition of estate taxes creates serious obstacles to the continuation of many companies. If cash for payment of estate taxes is not readily available, a company is faced with either liquidation or sale to another company, which is usually significantly larger and sometimes is foreign-owned. Both the amount of the tax and method of payment are crucial factors to the continuation of a construction company after the death of a controlling principal.

The Economic Recovery Tax Act of 1981 made a number of significant and beneficial changes in the estate tax laws. Some of these changes have not yet become effective. AGC supported the estate tax provisions in ERTA and continues to support them. We also support the sense of the Senate Resolution 126 which reaffirms the Senate support of the 1981 changes and their continued implementation.

Specifically, we support the scheduled increases in the unified estate tax credit up to $192,800 for decedents dying after 1987 and the scheduled reduction of the maximum estate tax rate to 50 percent in 1985.

Both the increases in the unified credit and scheduled estate tax reductions are necessary to help prevent forced sales of closely held family businesses in order to pay estate taxes. Together with the other ERTA changes, these provisions should not be tampered with.

AGC also supports the provisions of S. 1251. ERTA made a number of significant and beneficial changes in the availability and operation of section 6166, which allows for the installment payment of estate taxes. Despite these changes, qualification and administrative rules governing the installment payment of estate taxes continues to be an uncertain and unnecessarily awkward procedure.

The provisions of S. 1251 provide many technical revisions to this important aspect of estate taxes, which should be enacted by Congress.

While more significant reforms of estate tax laws may be made in future years, the technical corrections to section 6166 should be made now. These changes will not affect the estate tax liabilities. Only the method of payment is revised to provide certainty in business planning with some lessening of the initial impact of the estate tax liability.

It must be remembered that the availability and administration of the installment payment of estate taxes affects all small businesses—construction companies, farmers, and retail businesses. I would like to review several of the provisions of S. 1251 which are of particular concern to the typical estate, including a construction company or other closely held business.

The first issue concerns the clarification of corporate and partnership holding companies. In order to reflect present business practices, which often utilizes complex corporate and partnership holding company structures, section 6166 should be clarified to permit a decedent to own a direct or indirect interest in a corporation or partnership carrying on a trade or business.

There is no justifiable reason for the Internal Revenue Code to exclude partnerships and corporate holding companies from the benefits of section 6166. Failure of section 6166 to deal with this normal method of business planning only frustrates the congressional purpose underlying section 6166; that is, to provide a long-term payment procedure to estates to prevent forced sale or liquidation of the business.

Another example of a common business practice which should be supported by the Code rather than hampered is the treatment of postdeath buy-out agreements. Buy-out agreements are often an essential element in the continuation of a closely held business after the death of one of the owners. Section 6166 should be amended to permit an estate to sell its stock or partnership interest in exchange for a note without resulting in acceleration of estate tax liability.

Thank you.

[The statement of Mr. Carter follows:]

TESTIMONY OF
BILLY R. CARTER
FOR
THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA
PRESENTED TO THE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
OF THE
SENATE COMMITTEE ON FINANCE
June 27, 1983
ON THE TOPIC OF
ESTATE TAX ISSUES

Mr. Chairman and Members of the Committee.

Good morning, my name is Billy R. Carter. I am the Vice President of Finance of Nello L. Teer Company in Durham, North Carolina. I am testifying for the Associated General Contractors of America as Chairman of the Association's Tax and Fiscal Affairs Committee.

The Associated General Contractors of America (AGC) represents more than 32,000 firms, including 8,500 of America's leading general contracting companies which are responsible for the employment of more than 3,400,000 individuals. These member contractors perform more than 80 percent of America's contract construction of commercial buildings, highways, industrial and municipal-utilities facilities.

AGC's principal concern with estate taxes is to ease the burden of transferring a closely-held business following the death of a controlling principal. The construction industry is characterized by thousands of small firms which are highly competitive. These firms are often family owned and operated. The imposition of estate taxes creates serious obstacles to the continuation of many companies. If estate taxes cannot be paid a firm is faced with either liquidation or sale to another firm which is usually significantly larger. Both the amount of the tax and method of payment are crucial factors to a firm's continuation after the death of a controlling principal.

The Economic Recovery Tax Act of 1981 (ERTA) made a number of significant and beneficial changes in the estate tax laws. Some of these changes have not yet become effective. AGC supported the estate tax provisions in ERTA and continues to support them. We also support the sense of the Senate Resolution 126 which reaffirms the Senates support of the 1981 changes and their continued implementation. Specifically we support the scheduled increases in the unified estate tax credit up to $192,800 for decedents dying after 1987 and the scheduled reduction of the maximum estate tax rate to 50% in 1985. Both the increases in the unified credit and scheduled estate tax reductions are necessary to help prevent forced sales of closely-held family businesses in order to pay estate taxes. Together with the other ERTA changes, these provisions should not be tampered with.

AGC also supports the provisions of S. 1251. ERTA made a number of significant and beneficial changes in the availability and operation of Section 6166 which allows for the installment payment of estate taxes. Despite these changes qualification and administrative rules governing the installment payment of estate taxes continues to be an uncertain and unnecessarily awkward procedure. The provisions of S. 1251 provide many technical revisions to this important aspect of estate taxes which should be acted upon by Congress. While more significant reforms of estate tax laws may be made in future years the technical corrections to Section 6166 should be made now. These changes will not affect the estate tax liabilities, only the method of payment is revised to provide certainty in business planning with some lessening of the initial impact of the estate tax liability.

It must be remembered that the availability and administration of the installment payment of estate taxes affects ALL small businesses--construction companies, farmers and retail businesses. I would like to review several of the provisions of S. 1251 which are of particular concern to the typical estate including a construction company or other closely-held business.

The first issue concerns the clarification of corporate and partnership holding companies. In order to reflect present business practices which oftentimes utilize complex corporate and partnership holding company structures, Section 6166 should be clarified to permit a decedent to own a direct or indirect interest in a corporation or partnership carrying on a trade or business. There is no justifiable reason for the Internal Revenue Code to exclude partnership and corporate holding companies from the benefits of Section 6166. Failure of section 6166 to deal with this normal method of business planning only frustrates the Congressional purpose underlying 6166 - i.e. to provide a long-term payment procedure to estates to prevent forced sale or liquidation of the business.

Another example of a common business practice which should be supported by the Code rather than hampered is the treatment of post-death buy out agreements. Buy-out agreements are often an essential element in the continuation of a closely held business after the death of one

OF THE OWNERS. SECTION 6166 SHOULD BE AMENDED TO PERMIT AN ESTATE TO SELL ITS STOCK OR PARTNERSHIP INTEREST IN EXCHANGE FOR A NOTE WITHOUT RESULTING IN AN ACCELERATION OF THE ESTATE TAX LIABILITY.

SECTION 6166 SHOULD ALSO BE AMENDED TO ELIMINATE THE DISTINCTION BETWEEN VOTING AND NONVOTING STOCK, AND, THE DISTINCTIONS BETWEEN PARTNERSHIP CAPITAL AND PROFIT INTERESTS. UNDER PRESENT LAW, IF A CORPORATION HAS MORE THAN 15 SHAREHOLDERS (DETERMINED BY APPLYING ATTRIBUTION RULES), THE DECEDENT MUST OWN 20 PERCENT OR MORE OF THE VOTING STOCK TO QUALIFY UNDER SECTION 6166. THE DISTINCTION BETWEEN VOTING AND NONVOTING STOCK FOR THIS OWNERSHIP TEST SERVES NO VALID PURPOSE. THE DEATH OF A 20 PERCENT SHAREHOLDER CAN RESULT IN A BUSINESS DISRUPTION REGARDLESS OF THE TYPE OF STOCK OWNED. SIMILAR CHANGES ARE APPROPRIATE WHEN THE BUSINESS IS CONDUCTED IN THE FORM OF A PARTNERSHIP AND THE DISTINCTION IS MADE ON THE BASIS OF CAPITAL AND PROFIT INTERESTS.

ANOTHER OVERRIDING PROBLEM IN THIS AREA IS THE FACT THAT ANY DISPUTE WHICH ARISES UNDER SECTION 6166 CANNOT BE RESOLVED IN COURT, MAKING THE IRS THE SOLE ARTBITER OF ALL CONTROVERSIES. THIS INBALANCE BETWEEN THE TAXPAYER AND THE SERVICE NEEDS TO BE REMEDIED THROUGH THE CREATION OF A JUDICIAL FORUM TO RESOLVE DISPUTES. A DECLARATORY JUDGMENT PROCEDURE IN THE TAX COURT SUBJECT TO APPELLATE REVIEW PROCEDURES WOULD PROVIDE A SATISFACTORY SOLUTION.

THE ISSUES I HAVE JUST REVIEWED ARE ONLY THE HIGHLIGHTS OF S. 1251. WE BELIEVE THESE AND OTHER ISSUES CAN BE RESOLVED IN A MANNER THAT WILL

BENEFIT ALL CLOSELY-HELD BUSINESSES IN AN EQUITABLE FASHION AND NOT RESULT IN A SERIOUS REVENUE LOSS TO THE TREASURY.

BEFORE CONCLUDING I WOULD LIKE TO NOTE THAT IN THE PAST AGC HAS SUBMITTED TESTIMONY SUPPORTING FURTHER REDUCTIONS IN THE RATE OF ESTATE TAXES AND PROVIDING A SPECIAL VALUATION FOR CLOSELY-HELD BUSINESSES AT 50 PERCENT OF THEIR FAIR MARKET VALUE. WE CONTINUE TO BELIEVE THAT THESE ARE SOUND LONG-TERM OBJECTIVES IN THE AREA OF ESTATE AND GIFT TAXES THAT WILL HELP ASSURE THE CONTINUATION AND CONTINUITY OF THE THOUSANDS OF FIRMS WHICH MAKE UP THE CONSTRUCTION INDUSTRY. WE BELIEVE THESE ITEMS SHOULD RECEIVE A TOP LEGISLATIVE PRIORITY IN THE NEAR FUTURE. UNTIL THAT TIME WE HOPE CONGRESS WILL CONTINUE TO FOCUS NEEDED LEGISLATIVE ATTENTION TO THIS IMPORTANT AREA OF TAX LAW.

MR. CHAIRMAN THAT CONCLUDES MY REMARKS. THANK YOU.

Senator SYMMS. Thank you very much. Your entire statement will be made part of our record.

We now want to hear from a young man who was in town last year from Yuma, Ariz., that has a personal example of how these things can affect a family farm and ranch. We will now hear from Mr. Barkley.

STATEMENT OF ROBERT BARKLEY, YUMA, ARIZ.

Mr. BARKLEY. Mr. Chairman, thank you.

My name is Robert Barkley. I am here to urge enactment of at least certain provisions in S. 1251 involving section 6166. I manage a farming organization located in southwestern Arizona that has been owned by my family for over 60 years. I have submitted a written statement and am here to give a brief oral statement on the situation our farm is in today.

Senator SYMMS. Your entire statement will be part of our record.

Mr. BARKLEY. In the early 1900's my grandfather moved to the Yuma area and began to clear ground and farm in the Colorado River Valley. In the mid-1950's my father took over the operation of the farm. From that point on, the business developed into a farming organization employing approximately 150 to 200 people, including 60 to 70 full-time employees who have worked here for over 15 years, some as many as 40 years.

In August 1979, at the age of 53, my father was killed in an aircraft accident. At that point we were thrust into an extreme economic hardship. My father's estate planning was to elect to pay out the estate tax under the section 6166 deferred payment which, at the time of his death, carried an interest rate of 6 percent.

This would have been a difficult task, but attainable under normal conditions. The problems we faced are manyfold. One, an estate valuation much higher than was expected, increased interest rates on the balance of the tax, and extremely depressed farm income.

The year after my father's death brought about the worst inflation this country has seen in decades. This has caused expenses to skyrocket at the same time crop prices have gone to rockbottom.

With conditions like these, coupled with the extremely high interest rates charged on our estate tax, as high as 20 percent, we found it virtually impossible to pay only the interest, let alone the tax itself.

Federal and State death taxes, plus interest paid and accrued, amount to over 37 percent of the total value of our farm property, including my mother's community share. They amount to almost 75 percent of my father's gross estate for Federal estate tax purposes.

With this situation, the only solution is to sell assets to pay the tax, the very thing section 6166 was to prevent. If we are forced to sell, it would very likely mean selling the entire farm. This in itself would be a difficult task, with the way the farm economy has been over the past few years.

In the event of a sale of any portion of the farm, the underlying mortgages on our properties could become immediately due and payable. This, along with any income tax associated with the sale, could present an impossible task to overcome.

If S. 1251 is enacted it could be of great benefit to our family and our farm, along with others who are in the same situation. With the ability to receive an upfront deduction of interest, plus lower fixed interest rates, it may be possible to handle estate taxes under section 6166 deferrals and not have to sell our family farm.

Thank you.

[The statement of Mr. Barkley follows:]

Statement Before the
Subcommittee on Estate
and Gift Taxation
June 27, 1983

Statement of Robert K. Barkley, for the Estate of James F. Barkley,
re S. 1251, and in response to the Treasury Department's Views
With Respect to S. 2479, the Section 6166 Technical Revision Act
of 1982, Which was the Subject of Hearings
Before this Subcommittee on May 27, 1982

This statement is submitted on behalf of the estate of my father, James F. Barkley, to urge enactment of the provisions of S. 1251 (S. 2479 in the last Congress) which would enable my family to save the farm we have owned and operated for over sixty years. Specifically, those provisions are the ones which would

(1) permit an up-front deduction for federal estate tax purposes for the interest it is estimated will have to be paid under section 6166 of the Internal Revenue Code,

(2) gear the applicable interest rate to that paid on Treasury obligations of comparable maturity, and

(3) provide a transition rule enabling estates which have qualified for Section 6166 treatment, such as those of my father who died in 1979, to be covered prospectively by these provisions.

My father James F. Barkley died in an airplane crash in 1979. My mother, sister, brother, and I survived him. His principal asset was stock in the Barkley Company of Arizona, which operates a substantial farm in Yuma, Arizona, producing wheat, vegetables, and cotton. He and my mother owned all of the Barkley Company's stock.

Our farm currently consists of 3,800 acres. When my father died, it consisted of about 7,000 acres, but we were forced to sell land to pay off outstanding crop loans. Now, unless something is done, we may be forced to sell the remainder of the farm, mainly because of the substantial unanticipated amounts of interest we have had to pay to the Internal Revenue Service as well as the substantial amount of federal and State death taxes paid or owing.

After my father died, we elected to pay the federal estate tax that applied to the Barkley Company assets in installments under Section 6166 of the Internal Revenue Code, which permits closely-held businesses to do this. Our chief problem is that the interest rate on deferred estate taxes -- even after taking into account the 4 percent rate on a limited amount of that tax -- is too high, much higher than the yield we are able to realize from the farm and much higher than the 6 percent rate applicable when my father died. Since then, the interest problem has been aggravated by the introduction of compounding on January 1, 1983, and, although the interest rate on deferred tax is now lower, it is still very high (16 percent now, 11 percent beginning July 1). By reason of the resulting cash shortages, it has been impossible for my father's estate even to make timely payments of the last two annual installments of interest.

In fact, the amount of these payments in the past two years (over $1,040,000, including $502,000 of interest and $538,000 of State death taxes) is staggering, particularly since the Internal Revenue Service will only allow interest payments to be deducted when they are paid or accrued, and will not allow the deduction of anticipated interest payments. This denial of a deduction for interest in computing current installments due means that we have to pay interest on federal estate tax that we actually will never owe. Future installments would be adjusted, but that does not help us now. As a consequence, unless relief is forthcoming, the Internal Revenue Service position will destroy our business. Stated differently, the annual interest payments on the estate taxes currently due, standing alone, are so high that we cannot pay them without selling roughly 2,200 acres of the remaining land to raise cash, and if we sell that amount of land, we will only increase our problems, because a reduction of that magnitude will substantially decrease the efficiencies and therefore the value of the farm on a per acre basis. Further, with these same high interest rates due on items like farm equipment, and with the other expenses of administering the estate and running the farm, we could not possibly earn enough income from the 1,600 remaining acres to justify continuation of our operation. Sixteen hundred acres, while a substantial amount of land in some areas, is, in the semi-arid and arid regions of the West, simply inadequate to produce meaningful profits.

If we are forced to sell 2,200 acres, we are also faced with the problem of having to pay off all of the existing mortgages on our land in order to deliver unencumbered title to a buyer, because of "due-on-sale" clauses in our mortgages. This would trigger the sale of additional land to retire these mortgages. Even then, this would not be the end of our problems. The sale of the 2,200 acres would make the entire estate tax we elected to defer due immediately. So, obviously, if we sell any land to solve our problems (as we would have to do), we would have to sell all of it. That is something we definitely do not want to do.

The nation's farm economy is now generally depressed and prices for the commodities farmers sell are often below the cost to us of producing them. There have probably been more farm bankruptcies in recent years than there are new entrants into the farming sector. Thus, even if we wished to sell (and we most certainly do not), our family may have a hard time finding a buyer. To attract a buyer, we would probably have to sell the entire farm in one piece, because it is unlikely that 2,200 acres could be absorbed locally. Unfortunately, buyers who might be interested would probably be large agri-business firms or syndicates which usually look for larger units than the 2,200 acres we would have to sell.

I cannot believe that Congress ever dreamed that extremely high interest rates would be applied to the deferred estate tax payments permitted under Section 6166. Section 6166 was meant to allow families to retain the ownership of their closely-held businesses, such as our farm, rather than be forced to sell them to pay the federal estate tax, or the interest on such tax. Without the relief offered by S. 1251, we will have to sell our farm just to pay the interest owed. In effect, the high rates of interest, plus the inability to deduct that interest until paid, have neutralized the relief Section 6166 was intended to provide.

Enactment of the relief provisions of S. 1251 could save our farm, would reduce the staggering amount of interest that will have to be paid to a level that existed shortly before our father died, because we would be able to take one federal tax deduction for all of the interest payments we expect to make in the future, and would also make it easier to recompute our estate taxes once, upon taking the deduction, instead of every year as the current law as interpreted by the Internal Revenue Service requires.

An additional helpful aspect of S. 1251 is that if we have to redeem Barkley Company stock to pay death-related costs, such as the federal and state death taxes, interest, and other administration expenses, our estate taxes would not be accelerated. Without S. 1251, these taxes would be accelerated to the extent the redemption proceeds are used for any purpose other than to pay federal estate taxes. Even with S. 1251 there could be an acceleration problem if it should become necessary to sell land to pay the existing mortgages secured by the land, although we very much hope to avoid this result if S. 1251 becomes law.

The April 15, 1983, statement of the Treasury Department opposed the provisions of S. 2479 which would have provided relief for estates such as my father's. Three principal themes run through the statement -- (1) that Congress should not expand the benefits of estate tax deferral to businesses which do not qualify for deferral under present law, (2) that even under present law it is possible to qualify for deferral whether or not the estate has a liquidity problem, and (3) that a lower interest rate is, in effect, equivalent to a lower estate tax rate with respect to qualifying estates. Although the first two points may be valid, I respectfully submit that they should not be permitted to distract Congress from the urgent need for relief of estates which do qualify for deferral under present law but which, even so, experience a severe hardship in meeting their obligation to pay estate tax and interest. With respect to the third point, there is no question that when Congress passed the Tax Reform Act of 1976 it intended to provide interest relief, because "some businesses are not so profitable that they yield enough to pay both the estate tax and interest especially if the interest rate is high." (H.R. Rep. No. 94-1380, 94th Cong., 2d Sess. 30 (1976)). As indicated above, however, interest burdens have become much greater than Congress contemplated in 1976. Therefore, without the relief provided by the above-noted provisions of S. 1251 or similar legislation, there is no doubt that estates like my father's will be "forced to sell a decedent's interest in a farm or other closely held business in order to pay the estate tax" (id.) -- precisely the result under prior law which motivated Congress to pass the 1976 amendments.

The Treasury also argues that if a full federal estate tax deduction is allowed for interest, the number of estates that will qualify for Section 6166 treatment will be substantially increased, because of the consequent reduction in the adjusted gross estate, and thus there will be a substantial revenue loss. This, of course, is a result which can be avoided by appropriate statutory drafting. For example, under present law neither the charitable nor marital deductions are taken into account in determining whether an estate qualifies for Section 6166 treatment. Obviously, the Code could provide that installments of interest also be disregarded in determining the adjusted gross estate.

Finally, the Treasury has recommended that to simplify the computation of tax no federal estate tax deduction be allowed for installment payments of interest provided for under Section 6166. Our calculations show, however, that the rate of interest would have to be reduced to approximately 4 percent to compensate an estate for the loss of the deduction, even if the deduction is computed under the Internal Revenue Service's method whereby the interest is deductible only as it is paid. Unless Treasury were willing to reduce the rate of interest to this level or lower, its proposal would undermine the purposes of Section 6166 even more than do the existing high rates of interest

Thus, notwithstanding the policy objections of the Treasury Department to an expansion of estate tax deferral, enactment of the noted provisions of S. 1251 remains essential for the continuation of our family business and for family farms and ranches in general.

Robert K. Barkley

Senator SYMMS. Thank you all very much. I won't have any questions right now. I would just like to say I appreciate all of your testimony. Particularly, Mr. Delaney, we appreciate the technical solutions that you bring forward before the committee, and I hope that we will be able to enact some of this legislation, and I hope that we can sit down further and work out some of those details.

Mr. DELANEY. The section stands ready to help you and your staff.

Senator SYMMS. We appreciate that very much.

Now Mr. Barkley, it is my understanding that current farm income cannot pay the estate taxes over the lifetime of the individuals who inherited the farm, is what you are really telling us?

Mr. BARKLEY. That is right.

Senator SYMMS. So that is a real—back in the old days of "The Life of Riley" I think he would say that's a revolting development, wouldn't he?

Mr. BARKLEY. You could say that.

Senator SYMMS. In other words, what you are telling us is that you can't generate enough income to pay off this tax, so the farm will be sold, broken up, whatever, and it is a bad market to be forced to sell the farm into.

Mr. BARKLEY. At the moment, with the economic conditions that we face at the moment, we see no other way except to sell.

Senator SYMMS. Well, thank you very much. I hope we can do something and I think that you are all talking right to a point that is very important, and your being here makes the point of the necessity to do something now and not put this off and not delay it.

This is something more than just what the tax lawyers come up with in Washington, D.C. This is really a response from what is happening out in America, and there are real, live cases of families that are in a great deal of distress, waiting for a decision to be made in Washington, where we do so desperately need to get more predictability into our tax law. Particularly in the field of the estate taxes, we need predictability for those people who are affected by it, but also for those of you who are engaged in the activity of trying to plan estates. It becomes almost impossible to have this constant turmoil and lack of predictability in this tax code in this area for us to ever accomplish what is so necessary.

So I thank all of you very much. If we have some questions, we will submit letters. But we will move right on to our next panel, which is Malcolm A. Moore, chairman of the section of real property, probate and trust law, American Bar Association, and Vester Hughes, partner in Hughes & Hill in Dallas, Tex.

I understand, Mr. Moore, you are from the Northwest, Seattle, Wash.

Mr. MOORE. Yes.

Senator SYMMS. Great. And Mr. Hughes, you are from Dallas, Tex., correct?

Mr. HUGHES. That is correct.

Senator SYMMS. All right, Mr. Moore, you go right ahead.

STATEMENT OF MALCOLM A. MOORE, CHAIRMAN, SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW, AMERICAN BAR ASSOCIATION

Mr. MOORE. I am Malcolm Moore, chairman of the section of real property, probate and trust law of the American Bar Association. I am pleased to appear today on behalf of the entire American Bar Association to reaffirm its view that the generation-skipping tax should be repealed and it should be repealed now.

Mr. Delaney, as chairman-elect of the section of taxation, has already testified on section 6166. His section, as part of the ABA, joins us in this statement with respect to repeal of the generation-skipping tax.

You have already heard from Mr. Woodward with respect to an analysis of the proposals the Treasury Department has made to simplify the tax. The Treasury Department also has called for repeal of the tax, the present tax, so long as its proposals are enacted.

The appropriate committees of real property, probate and trust law and the taxation sections of the ABA have made a preliminary review of the proposals and of course, while they are not in statutory form, and therefore it is impossible to really make a complete review of them, I did want to share with you some preliminary comments resulting from those efforts.

First some background. As far as the generation-skipping tax is concerned, it was enacted, as we all know, in 1976. Ever since then, both the Treasury Department and lawyers in the private sector have been struggling with the law—the Treasury Department as to how to administer it and the practitioners on behalf of their clients with respect to how to understand it and draft instruments taking it into account. I would have to say that neither group has been successful. In fact, we have both failed.

No final regs, as far as the Treasury's part is concerned, I think is evidence of the nonsuccess there. No final regs have been issued on the substantive aspects of the law, despite the fact that we are now 6 years after the law was passed, even though the statutory language of chapter 13, the generation-skipping tax, relies heavily on regs to fill in the holes.

Well, we haven't seen any regs and presumably, we are not going to see them, now that even Treasury concedes that the present law should be repealed.

It took until December 1982 for the Treasury Department to produce forms which taxpayers could use to file in connection with the generation-skipping tax. Whether any tax has actually been paid, I don't know. I know some returns have been filed, though not very many. So I think that is evidence that the Treasury Department has had great difficulties administering it.

As far as the private sector is concerned and the practitioners, we have spent countless hours of continuing legal education time and time drafting in an office for our clients. Our clients have spent a lot of money and frankly, a lot of resources of the organized bar has been put into educating the lawyers on present chapter 13, and that has not been a great success. I would say that few lawyers today have a really good grasp of the way chapter 13 operates. We all have questions about it. Those of us who consider ourselves experts are still mystified by a number of parts of the law.

With that as a background, I think we have no alternative but to say the law has not worked; it should be repealed now. It would be nice to have a substitute with which to replace it, but frankly, we don't have one. We have a proposal from the Treasury Department in essay form. A statute has not been drafted. Mr. Woodward says he is working on a draft but we have not seen a statutory draft yet. No complete analysis of those proposals can be made until we see statutory language.

Well, how long will that be? Probably too long for purposes of having to continue to live with the present law. Treasury Department testified in November 1981 with respect to its proposals. It was not until late April 1983 that they were put into essay form. That is quite a long time.

The statutory language is probably quite a ways off, and I think that it really is unfair to require our clients and those members of the practicing bar to continue to be in this quagmire that we have been in for the last 6 years. I think that it is going to be a protracted period of time before we see any agreement, if we see agreement on substitute proposals. We know the Treasury Department is overburdened. There are many things that it has to pay attention to other than this, but recognizing that, I think we just have to acknowledge that it is going to be a long time before we see any light on the horizon.

Another factor is that groups such as the American Law Institute and some other bar groups are currently engaged in efforts to see whether a workable solution to the generation-skipping transfer tax problem can be found. It seems to me that those groups should be given a reasonable opportunity to complete their efforts before we hastily enact some proposal which, as you said earlier, may find us back here 2 years from now saying we should repeal it.

In any event, I think that those people should be given perhaps not the 6 years it has taken the Treasury to try to make this law work. I think that could be done in a much shorter time.

The law should be repealed now. It doesn't work. It is draining the energies of both the Treasury Department and the private sector, and there isn't any quick fix on the horizon.

If I could, I would like to take another 3 minutes or so just to give you a summary of at least the preliminary review of the Treasury's proposals and what the committees of the two sections that I mentioned before have come up with thus far.

Senator **SYMMS**. We would like to have that in the record.

Mr. **MOORE**. It is only preliminary. We can't analyze it until we have seen the final statutory language or the proposal statutory language.

First, I think we applaud the Treasury's efforts in terms of simplifying the law. It needs simplification and we applaud those efforts. We applaud their efforts with respect to the $1 million exemption. That does in fact take a lot of people out of the system. We are just afraid the $1 million exemption may not stay at $1 million. I think that we all know what happened to the proposed $1 million grandchild exclusion. It got reduced to $250,000 and the exclusion for employee benefits which started at $500,000 got reduced to $100,000.

So we certainly applaud that exemption which takes a lot of taxpayers out of this system, but it is a key part of the proposal and we hope that that amount remains.

If you examine the Treasury proposals, however, and again, this is just from our preliminary review of them, you see several substantial departures from the concerns expressed in 1976 with respect to this tax, and in fact, some inconsistencies with our present transfer tax system. Let me just mention a couple of them. They are all detailed, to the extent we have been able to thus far, in the written testimony.

First of all, the taxation of direct transfers to grandchildren is something new. It would mean that a client would pay a tax on a direct transfer to a grandchild, when that is not the case now. This would include children whose parents are dead. It would be direct transfers, as Mr. Woodward said this morning. It is a shift of emphasis. The concerns in 1976 underlying the present chapter 13 had been that if an older generation and a younger generation were sharing the benefits of the trust, that that was an appropriate time to tax it. For generation-skipping purposes, it had not been suggested in 1976 that a direct transfer was subject to tax.

I think I would find it difficult to explain to a client of mine why transfers to his grandchildren, a child whose parent was deceased, should be taxed at a heavier rate than transfers to his own children. I would find that very difficult to justify to my client. The Treasury Department has stated that it is more natural to give to children than to grandchildren. I am not sure that is the case when you consider the great educational expense in this country and grandparents wanting to benefit their grandchildren directly with respect to those things.

So, the taxation of direct transfers to younger generation beneficiaries really addresses a concern that we didn't think was a concern, or at least Congress had not articulated in 1976. As Mr. Woodward pointed out this morning, I think Congress is going to have to determine whether it wants to get into that area of taxing those kinds of generation-skipping transfers.

What we really have now is the Treasury proposal would put us, in a way, into a multitiered inheritance tax structure, as opposed to an estate tax structure, where who you are depends on what tax you pay. The younger generation beneficiaries would have their property taxed more heavily than transfers to children, for example.

Another aspect of the proposals are that now income distributions from trusts, for instance, are subject to the generation-skipping tax. We have never before really had income subject to transfer tax in this country. The Treasury proposals would, in fact, have that effect, and you can see if there are two grandchildren, one of whom got the property outright and another who is 2 years younger and had it in trust, under certain circumstances the income from that trust would be subject to a generation-skipping tax whereas the other grandchild would have gotten the property without any tax. And one has to ask whether that is fair, whether that is logical.

The $1 million exemption, Mr. Woodward has already said that the Treasury would take into consideration providing somehow for more effective use of that as between spouses so that the spouses would have $2 million between them, rather than $1 million. We hope that that occurs.

The rate of tax, of course, is a matter for Congress to determine. I should just point out that a flat rate has now been proposed of 80 percent of the maximum estate tax rate, which is currently 50 percent, so the flat rate would be 40 percent.

The current top rate for income tax and gift tax and estate tax is 50 percent. I think, as you pointed out earlier, a combination of the generation-skipping tax with the gift or estate tax will put someone in a bracket of approximately 64.3 percent without even considering additional taxes imposed by States or cities. So, I think, in fact, we have, as you pointed out earlier, a transfer tax well in excess of the current 50-percent maximum. That is something that Congress will have to address, but it is in the Treasury proposals.

I think that there are many more things I could say but in the interest of time, I would just like to summarize, if you look at the Treasury proposals, what Congress is going to have to consider in terms of some reversals of policy and some inconsistencies with present law.

For one, the proposals would have the result of partial loss of unification of the transfer tax system. Their proposals would once again make it advantageous from a tax standpoint to make lifetime gifts rather than testamentary bequests. Better look at that.

A loss of the maximum 50-percent transfer tax. We now have a tax that would be in excess of that.

Transfer taxes would be based on the right to receive property rather than a right to transfer it. That is the inheritance tax versus the estate tax. We have never had an inheritance tax at the Federal level. Thought has got to be given to whether we should have that.

Gratuitous transfers have never before been subject to income tax. Now income is being subject to transfer tax.

I think that after looking at the Treasury proposals and giving them a preliminary review, you see that there are a number of things to think about. When the statutory language comes out, there will be further things to think about. All of this will take time.

The American Bar Association therefore reaffirms its position that the present generation-skipping tax should be repealed. It doesn't work. Great resources have already been wasted on it. Let's not waste many more resources on it. Let's see what can be done in a constructive way where we are not rushed, where we are not hastily enacting legislation which we might regret in the very near future.

Thank you for the opportunity to appear before the subcommittee.

[The statement of Mr. Moore follows:]

STATEMENT OF

MALCOLM A. MOORE, CHAIRMAN
SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW
AMERICAN BAR ASSOCIATION

before the

SUBCOMMITTEE ON ESTATE AND
GIFT TAXATION

of the

COMMITTEE ON FINANCE

of the

UNITED STATES SENATE

concerning the

TAX ON GENERATION-SKIPPING TRANSFERS

June 27, 1983

I am Malcolm A. Moore, Chairman of the Section of Real Property, Probate and Trust Law of the American Bar Association. I am pleased to appear today on behalf of the Association to reaffirm its view that the generation skipping tax should be repealed. Agreeing with the need for repeal of the present generation skipping tax, the Treasury Department has recently made some proposals for an alternative approach to the tax. The appropriate committtees of the Association's Sections of Real Property, Probate and Trust Law, and Taxation, have been studying these proposals and while neither Section has completed its study, I wanted to share with you some preliminary comments resulting from those efforts.

I. Background of the Present Generation-Skipping Tax.

The generation-skipping tax, embodied as Chapter 13 of the Internal Revenue Code, became law in 1976 as part of the Tax Reform Act of 1976. While there were some hearings with respect to that legislation in general, the generation-skipping tax provisions were not reviewed at length or in depth by the American Bar Association or a number of other interested professional organizations. Neither was there a substantial degree of time devoted by Congress to the consideration of those provisions.

Chapter 13, as enacted, has been a failure. It has met with widespread and well-founded criticism by professional organizations and many individual practitioners. Despite countless hours of continuing legal education efforts on the part of the organized bar, and countless other hours devoted by lawyers and other professionals to trying to cope with the generation-skipping tax provisions, few professionals have a been able to develop a real understanding of the law. Furthermore, the Treasury Department has found the law practically impossible to administer.

In August 1981, the American Bar Association urged repeal of the law because it was found to be unworkable. In November, 1981, the Treasury Department admitted that there were severe problems with the law and at a hearing before this Subcommittee, suggested several possible ways in which the law could be amended to make it more comprehensible and workable. In December, 1982, a retroactive moratorium on the law's application passed the Senate, but in the House-Senate conference committee deliberations, the moratorium was dropped.

On April 29, 1983, the Treasury Department released a proposal in essay form which would fundamentally change the generation-skipping transfer tax in order to "simplify and improve" it. The need for Treasury's proposal was occasioned by the criticism of the present Chapter 13 by professional organizations and individual practitioners. In presenting its proposal, Treasury conceded that the present law is too broad in scope, too complex for comprehension, unworkable from an administrative standpoint, inequitable in application, ineffective in taxing generation-skipping transfers, and unfair and lacking in logical consistency. The American Bar Association agrees with the Treasury's conclusions with respect to present Chapter 13 and, in light of these criticisms, urges its immediate repeal. The Treasury proposal would repeal the existing generation-skipping tax retroactively, but presumably only in conjunction with enactment of its new generation-skipping provisions.

II. Need for Immediate Repeal of Chapter 13.

The present posture is thus one of the Treasury admitting that present law is unworkable, and favoring its retroactive repeal at such time as its new proposal is enacted. We can appreciate Treasury's unwillingness to have present law repealed before a substitute is in place, but it is extremely unfair and inappropriate to suspend lawyers and their clients in limbo for what will be in all probability a protracted period. Although eventual repeal of the present generation-skipping tax now seems all but a certainty, and on a retroactive basis, prudent lawyers will continue to try to comply with present law, resulting in unnecessary legal fees charged to clients, and possibly payment of a tax which is likely to be retroactively repealed.

Putting taxpayers and their advisors in that position simply perpetuates the quagmire in which we have all had to work since 1976. For every year since then, through the end of

1982, lawyers were obligated to refrain from making any changes in revocable trusts and wills of clients executed before June 11, 1976, which could jeopardize the "grandfathering" extended to those preexisting instruments during those years. The avoidance of such changes in many cases resulted in tortured estate plans which pleased neither the lawyer nor his client. For those clients without grandfathered instruments, the quagmire consisted of having to draft wills and trusts keeping in mind generation-skipping tax provisions which despite bona-fide attempts by the estate planning community to educate itself about the new law, have never really been adequately understood. Taxpayers presently find themselves in the incongruous position of not having to consider the federal gift or estate tax in estate planning matters by reason of existing and phased-in exemptions, but at the same time having to take into consideration the implications of a soon to be radically reivsed Chapter 13 when doing their estate planning.

If there was now an extant proposal in statutory form which had received general approval both by the estate planning community and the Treasury Department, and we were talking about only a month or two of uncertainty and indecision, repeal could await the enactment of those new provisions. However, at this time, the Treasury proposal is not in statutory form, and it will probably be many months longer before it is. Given the directions which the Treasury proposal takes, which will be discussed later, there will be no quick agreement on the proposal. Furthermore, experience shows that the process of drafting statutory language often brings to the surface technical problems which were not foreseen when the broad outlines of a proposal, such as Treasury's, were written.

Thus it is clear that there is no "quick fix" on the horizon. That conclusion is supported not only by present circumstances, but is also borne out by past history. Treasury's ability to cope with Chapter 13 has been no greater than the estate planning community's. For example, it took more than six years to adopt forms which taxpayers could use to report a generation-skipping tax transfer. No final regulations with respect to the substantive tax provisions have ever been issued and now, presumably, never will be, because everyone agrees that the present statute will not survive as we know it. As pointed out earlier, it has taken more than 18 months (from November of 1981 to April of 1983) for Treasury to develop the November 4 testimony to the essay form of its current proposal. With the many far more significant revenue raising drafting projects awaiting attention of Treasury, it is difficult to believe that new statutory language of Chapter 13 will be forthcoming soon.

Other responsible bodies are currently considering whether it is possible to produce a workable and understandable transfer tax which addresses the concerns expressed in 1976 with respect to generation-skipping transfers. For example, the American Law Institute has undertaken a project to see whether there is a satisfactory way to deal with the question. The A.L.I. consultants and their reporters have just had their first meeting and it will be, naturally, some time before the direction of their deliberations is known. They should at least be given the opportunity to complete their studies before Congress acts on a different proposal.

For the foregoing reasons, the American Bar Association continues to urge immediate repeal of the present statute. Only after repeal of the present Chapter 13 can any new proposal be reviewed and considered in an atmosphere conducive to producing, if possible, a workable, fair and effective tax on generation-skipping transfers. Both Treasury, the practicing bar, and organizations such as the American Law Institute, should be given time to do this. The Treasury Department and Congress have had over six years within which to make the present law work. Certainly a reasonable time (which will be much shorter than six years) should be accorded the responsible efforts now ongoing to see whether a workable solution can be reached.

III. The Treasury Proposals in General.

The Treasury is to be commended for having given careful thought to what alternatives there might be to the present Chapter 13. The effort, by way of the proposed $1,000,000 exemption, to take most taxpayers out of the generation-skipping taxpaying system, is to be applauded, as is its stated intention to try and reduce complexity in the statute's operation and administration. The American Bar Association, its Sections, and relevant committees, is prepared to give further study to these proposals, and particularly so when specific statutory language is offered for consideration. Other professional groups will no doubt do the same. However, the Association, through the efforts of committees of the Sections of Taxation and Real Property, Probate and Trust Law have already spent some time studying the concepts set forth in Treasury's proposal and the following comments reflect some preliminary thoughts and considerations regarding them.

IV. Scope of Law's Application is Not Narrowed.

The Treasury indicates that its new proposal will significantly limit the scope of application of Chapter 13. However in two significant respects the proposal expands the types of transfers which attract the tax. The proposal's most dramatic change is to expand the definition of generation-skipping transfers to include all direct transfers to persons more than one generation younger than the testator or donor. The scope of the tax is also enlarged to encompass distributions of trust income to a grandchild or other person in more than one generation below the donor. The enactment of both of these changes not only greatly expands the scope of

Chapter 13 but is also evidence that Treasury has lost sight of the original purpose behind the enactment of Chapter 13.

A. Inclusion of Direct Transfers.

The 1976 legislative history of Chapter 13 clearly indicates that Congress was concerned about the enjoyment of wealth by intervening generations without the payment of a transfer tax. Congress was not concerned with gifts to grandchildren and younger generations where no one else had enjoyment of the property. In other words, despite its name, the generation-skipping tax was originally conceived to tax those transfers which did not in fact skip a generation. This dramatic policy change to include direct transfers deserves very careful consideration before enactment. Not only is this not a step toward simplification, but it is a substantial reversal of prior policy. Paradoxically, the proposal tries to answer a "problem" which was not perceived to be one in 1976. At the same time, by creating a one generation-skipping tax per transfer rule, it fails to adequately address the 1976 concerns.

Treasury reasons that "logical consistency" compels the inclusion of direct transfers in the definition of "generation-skipping transfers" so that taxpayers will not avoid the consequences of Chapter 13 by dividing their estates among children and grandchildren - the so-called "layering" concept. The reasons for Treasury's belief that outright gifts to younger generation beneficiaries should be subject to an additional transfer tax is difficult to comprehend. Whether a generation-skipping tax should be paid on such transfers is most debatable, and certainly is not suggested by the legislative history underpinning the current Chapter 13.

The Treasury proposal states that the "natural" way of giving is to the child generation, implying that direct giving to the more remote generations is not natural. The incorrect assumption underlying Treasury's approach is that absent tax motivation, all grantors would always transfer all property down only one generation. This is simply not the case. For example, in the last decade when the costs of education have increased so dramatically, many grantors have given or willed property directly to grandchildren to help defray educational expenses. This is but one of many examples of where factors other than the recipient's generation level motivates transfers to him. Under the Treasury proposal, direct transfers are also placed at a timing disadvantage compared to transfers benefitting two generations of the type subject to tax under current law, since the generation-skipping tax on the corpus of the two generation transfer is not payable until the death of the older generation beneficiary. Direct transfers would be taxable immediately.

Treasury also indicates that a tax on direct transfers is needed for simplicity. Simplicity, without a sound public policy basis, is not adequate justification for the tax on direct transfers. Furthermore, if simplicity is the stated goal, Treasury should recognize that the tax on direct transfers in reality converts our present estate tax to a complicated, multi-tiered inheritance tax. If the Treasury's proposal as presented is enacted, the country will have a transfer tax system which exempts spousal transfers, imposes one rate of tax on children, nieces and nephews and other persons less than 37-1/2 years younger than the transferor, and imposes a higher rate on grandchildren, great nieces and great nephews and other persons more than 37-1/2 years younger than the transferor.

One of the important considerations that will face Congress in its debate over the taxation of direct transfers under Chapter 13 is whether the transfer tax should discourage the fragmentation and redistribution of family wealth. Under the proposed Chapter 13 changes, the presence of different tax rates will encourage concentration of family wealth in the hands of the children. There are some who would say that the encouragement of such a policy is inappropriate. Others would say it is against public interest.

In light of Treasury's statement that the present statute is unfair, the application of the direct transfer rule to the children of a predeceased child who had no enjoyment of the property can hardly be considered an improvement. Such grandchildren without a parent are often in much more need than living children, yet the Treasury's proposal, by the imposition of the generation-skipping tax, would reduce the assets available to them. Consistent with this premise, in 1976 Congress enacted the orphans' deduction on the theory that those whose parents died prematurely would need access to more assets than those whose parents were living. The enactment of the Treasury's proposal will penalize these very same beneficiaries. We would have moved from an orphans' deduction to what could amount to an orphans' tax in six short years.

B. Inclusion of Trust Income Distributions.

If outright transfers to persons more than one generation younger than the donor are to be taxed, then in keeping with the Treasury's desire for "logical consistency", income distributions to persons more than one generation younger than the grantor must be taxed. However, if Treasury's objective is to impose a tax analogous to the estate or gift tax imposed on a direct transfer to child who in turn immediately transfers it to a grandchild, the income exclusion should be retained. Income from given property is not subject to gift tax - only the underlying principal. Furthermore, the accomplishment of this logical consistency will lead to serious theoretical problems, computational difficulties, and unduly high tax rates.

As to tax rates, the combined maximum income tax rates (both federal and state) plus the generation-skipping tax could be onerous. Disregarding state and city income taxes, the effective combined federal income (50%) and generation-skipping tax (40%) rates after giving effect to the income tax deduction for the generation-skipping tax would be 70%. This is far in excess of the 50% top bracket for both income tax and estate tax when the ERTA rate reductions are fully phased in. Further, it is not clear whether the generation-skipping tax would be imposed on the after-income-tax amount received by the beneficiary.

It is not clear whether under state law the generation-skipping tax on income distribution will be charged to income or principal. If principal is charged, trust remaindermen will pay the income beneficiary's tax. To cure the resulting inequity will require difficult adjustments to be made during the trust's term. This potential added complexity should not be created without adequately considering its consequences.

The subjection of income distributions to Chapter 13 may produce very different tax results for two grandchildren a few years apart in age whom the testator otherwise intended to treat equally. Grandchild A, age 37, is given his property outright and a gift tax as well as a generation-skipping tax is paid on the total value. Grandchild B, on the other hand, is under age 35 so his share passes into trust in which his father could share, if needed, for medical expenses. An immediate gift tax is paid on the underlying principal, and a Chapter 13 tax is paid on any income distributed to Grandchild B prior to termination of the trust. Upon termination when Grandchild B reaches age 35, a further generation-skipping tax is paid on the trust principal. Can such potential disparity between the beneficiaries where the intention was equal treatment be justified? We believe it cannot be.

Additional complexity will be encountered in trusts where a portion of the income is accumulated for later distribution during the trust's term or upon termination. The generation-skipping tax, the income tax deduction therefor, the income tax and the throwback rules all must be considered in planning and administration. Only the most sophisticated lawyer will be able to cope with, much less recognize, these interrelations. Even those highly specialized advisers should not be required, at their clients' expense, to spend the hours of effort necessary to understand and deal with all these nuances.

V. The $1,000,000 Exemption.

The Treasury has suggested that the first $1,000,000 of generation-skipping transfers should be exempt from the tax. This is the cornerstone of Treasury's attempts to narrow the scope of the tax. It is one of the most important elements of the proposal and one which we applaud. The amount of the exemption would appear appropriate to avoid the imposition of the tax on many medium-sized and smaller estates. However, those involved with the original proposal for Chapter 13 will recall that the grandchild exclusion of $250,000 under the present statute was originally slated to be $1,000,000 and that the recently enacted $100,000 exclusion for retirement benefits from federal estate tax was originally proposed to be $500,000. Any reduction in the proposed exemption amount (which could easily happen in the course of Congressional consideration) would seriously threaten the viability of the Treasury's entire proposal by having Chapter 13 apply to taxpayers who truly should be taken out of the system.

A. Coordination With Spouse's Estate Difficult.

Treasury states that a married couple may easily plan their estates up to $2,000,000 in value without concerning themselves with Chapter 13. This statement is true, but only if (1) the spouses decide not to use the unlimited marital deduction at the first death or (2) the spouses are wealthy enough to utilize both exemptions through lifetime gifts or (3) the wealthy spouse gives enough to the non-propertied spouse to enable each to fairly utilize the $1,000,000 exemption or (4) the order of deaths is "correct" from a tax standpoint.

For example, assume that one spouse has a $1,000,000 generation-skipping tax exemption but no assets, while the other spouse has an estate of $3,000,000 and a desire to leave everything directly to the grandchildren. If inter vivos transfers are not made either to the grandchildren or to the impecunious spouse, there will only be a $1,000,000 exemption available. This results from there being no provision in the

Treasury proposal for bequeathing one's unused $1,000,000 generation skipping tax exemption to the surviving spouse — either to a QTIP trust or otherwise.

B. Election Decisions Will Be Difficult.

Since the liability for paying the tax will frequently be left in the hands of a fiduciary rather than the donor, potential conflicts will arise in the allocation of the exemption among multiple recipients in different circumstances, particularly in the absence of instructions from the testator. For example, assume that a testator establishes trusts for each of two living children and the daughter of a pre-deceased child. Each trust terminates when the income beneficiary attains age 50. Should the executor elect the entire exemption for the grandchild's portion assuming the two children will live to age 50, realizing that if either child does not live to age 50, the grandchildren will be treated substantially unequally? Or, in the alternative, should the executor elect only one-third of the exemption against the grandchild's share, reserving the balance for the other children in case they do not survive to age 50, but, of course, running the risk that $666,666 of the exemption will be lost if both children survive the termination of the trust?

The Treasury's statements indicate that a refund may not be obtained even if, after paying the generation-skipping tax, it turns out that a person's total transfers fall within the $1,000.000 exemption. Clearly refunds should be allowed.

VI. Tax Computation.

With the inclusion of direct transfers in the definition of generation-skipping transfers, the computation of the tax becomes two-pronged. Treasury urges a different tax treatment for direct skips than for generation-skipping trusts. The result is that there will be a varying amount of tax paid on the same gift to the same person depending on whether it is made during life, at death, outright or in trust. The result is clearly inconsistent with the unification of the estate and gift tax.

A. Differentiation of Tax Base Unwarranted.

The distinction between the generation-skipping transfer tax base for direct transfers and all other generation-skipping transfers is not warranted. Direct skips will be taxed on a "net-now" basis, viz., the tax will be computed only on the net amount actually received by the beneficiary, whereas all other generation-skipping transfers will be taxed on a "gross-then" basis which will include the Chapter 13 tax in the generation-skipping tax base. Is this an attempt to perpetuate the present distinction between the tax base for gift tax purposes from the base for estate tax purposes? There is no rationale for extending this disparity into Chapter 13. The inconsistent manner in which the gross-up principle applies results in more than a 12% spread in the transfer taxes paid, depending solely on the manner in which the transfer is made.

This disparity was probably unintended, but should be eliminated by using only the net amount passing to the transferee in each instance or grossing up the generation-skipping tax into both the estate or gift tax base in each instance. It would seem more logical to adopt the former position and avoid a "tax on a tax." On the other hand, in no case should the estate and gift taxes paid be grossed up into the Chapter 13 tax base. Any estate or gift taxes paid will not increase the amount of the Chapter 13 transfer, and, furthermore, would apply whether or not the transfer involved Chapter 13.

Finally, we disagree with the proposal's provision that the generation-skipping tax should be treated as an additional gift subject to the gift tax. Why should this gross-up be required?

B. Relief Provisions Needed.

The Treasury's proposal does not mention any of the special tax deferral or relief provisions such as Section 6166 (deferred payment of estate taxes for owners of closely-held businesses), Section 2032A (the special use valuation), Section 303 (redemptions for payment of death taxes and administration expenses by owners of closely-held businesses), which are available in the estate tax context. Hence one must assume that Treasury does not intend that these relief provisions would be available with respect to any generation-skipping tax paid under its proposal.

This limitation is not justifiable under the present Chapter 13 where more than one generation must enjoy use of property before the generation-skipping tax would apply; with the inclusion of direct transfers in the Chapter 13 base, the unavailability of these relief provisions becomes even less justifiable. There is no justification for the rule that the farmer who passes the farm to his son may enjoy the benefits of the relief provisions mentioned above but the generation-skipping tax paid by the farmer whose son is deceased so that the farm must pass to the grandson should be denied the benefit of these same relief provisions. Indeed, these relief provisions were enacted to assist farmers and owners of closely-held businesses in the payment of their death taxes. How can these same owners of illiquid assets be expected to be in any better position to pay Chapter 13 taxes?

C. Proposed Use of Section 2013 Unclear.

One provision that warrants special mention in the Treasury's proposal is Section 2013, the credit for tax paid on prior transfers. This provision provides a credit to a transferee's estate if federal estate tax has been paid on the same property within the preceding ten (10) years or the succeeding two (2) years because of a close succession of deaths. The proposal's description of interface of Section 2013 with Chapter 13 is so unclear that it is difficult to fathom exactly what the Treasury is proposing, except that in most instances Section 2013 treatment will not be available for Chapter 13 taxes. However, in order to further Treasury's goal of logical consistency, the treatment under Chapter 13 ought to be the same as though the transfer were in fact what Chapter 13 theoretically treats it as being: an outright transfer to the skipped generation, followed by a gift to the recipient generation with the appropriate Section 2013 credit allowed. In any event a clearer explanation of the Treasury's position on this point is needed before adequate comment can be made.

D. Flat Rate.

The Treasury proposal would impose a flat tax of 80% of the maximum estate tax rate. There will no doubt be disagreement about whether imposition of a flat rate of tax under our system of transfer taxes is appropriate. The flat rate does eliminate the computational and reporting problems that resulted from the "deemed transferor" concept. Therefore, although the flat rate represents a departure from what historically had been a progressive tax rate system, the administrative simplicity is attractive.

However, many persons will feel the proposed rate is simply too high. When the reduction to a 50% estate tax bracket is fully phased in, the combined marginal estate and generation-skipping tax rate for all estates in excess of $2.5 million will be as high as 64.3%. Not only is this in excess of the top income and transfer tax rates after full phase in of the rate reductions in ERTA, but it is also in excess of the marginal rates (at certain levels) before the phase-in. This does not include any state death taxes and, in the case of many states, the state's generation-skipping tax. Moreover, in many cases a Chapter 13 distribution will also have income tax consequences because of carrying out of distributable net income without in fact distributing income. Thus, the effective combined rate could easily exceed 75%, well in excess of pre-ERTA top rates.

One serious deficiency in the 40% rate is that it appears to be based on the fallacious assumption that the skipped generation will have assets not only in excess of the full exemption equivalent of the unified credit — $600,000 in 1987 — but that all those beneficiaries will be in the top 50% (by 1985) estate tax bracket. There will be many skipped beneficiaries whose assets will fall far below this level. This will frequently be the case where a child has predeceased the transferor without ever having built up an estate. Furthermore, many generation-skipping trusts are used because the skipped generation has not demonstrated an ability to handle money properly; consequently, these trust beneficiaries often will have little or no property, and their unified credit would completely shelter their own property from transfer tax.

The unfair results of this assumption can be dramatically demonstrated by the following example. If the transferor leaves his estate of $3,000,000 after death taxes equally to his four children, none of whom has accumulated any property as yet, and all four children died shortly thereafter, passing the property to grandchildren, the total tax due from all four estates combined would be $222,000. Alternatively, if the transferor created a discretionary trust for his four children and their issue and applied his full exemption against the trust, the remaining $2,000,000 would be subject to an $800,000 generation-skipping tax ($2,000,000 x 40% = $800,000). Given this significant penalty, there is a substantial argument that even though a flat rate may be appropriate as a trade-off in favor of administrative ease, the 40% rate is excessive.

VII. Transition Period Too Short.

The Treasury's proposal suggests a transition period of one year to allow taxpayers to change their wills and revocable trusts. Most estate planners have just gone through a period of "rewrites" of documents for all married individuals to take account of the recently enacted unlimited marital deduction. Based on this experience, it is clear that one year will not be sufficient time for practitioners to learn the provisions of any new statute, consider its application on all estate plans, convince their clients of the need for yet another rewrite, and implement the changes where required. Many documents drafted (and redrafted) since 1976 have skipped an entire generation completely. Under the proposal it may be preferable to give the intervening generation a life estate in order to defer and (with the reduction in federal estate tax rates) possibly reduce the total transfer tax payable. This change should probably be made even when the estate in question currently falls witin the exemption limits. Also, many children and young adults have general powers of appointment as a result of trust provisions designed to qualify for the grandchild exclusion, or provision has been made for property to pass to the grandchild's estate. Many parents and grandparents will want these provisions deleted; indeed, they did not want them in the first place, but were told they were necessary to qualify for the grandchild exclusion. All of these changes will take time.

VIII. Reversals of and Changes in Tax Policy.

An analysis of the foregoing critique of the most salient points of Treasury's proposal to simplify Chapter 13 forces one to conclude that a number of previously expressed and enacted transfer tax policies are being reversed or ignored by the Treasury's proposal. A partial list of such changes in tax policies would include the following:

1. Loss of unification of the transfer tax system. New Chapter 13 would once again make it advantageous from a tax standpoint to make lifetime

gifts rather than testamentary bequests. A maximum 12.1% transfer tax savings is available for an outright gift, without considering the income tax implications.

2. Loss of the maximum 50% transfer tax. The Treasury's proposal abandons the policy that the government will not take more than half the taxpayer's property through either the transfer tax or income tax.

3. Transfer taxes will be based on the right to receive property rather than the right to transfer it. The age and relationship of the recipient to the donor will determine the rate of tax. Thus, we will have some elements of an inheritance tax rather than a true estate tax.

4. Gratuitous transfers have never before been subject to income taxation. Now income will be subject to transfer tax.

5. Revenue-sharing will be reduced by the lack of any state tax credit for the generation-skipping transfer tax.

6. The credit under Section 2013 for federal estate tax imposed on the same property twice within 10 years because of close succession of deaths will not be allowed where the tax is a combination of federal estate tax and Chapter 13 tax.

If the best attempt to create a rational, fair, effective and enforceable tax on generation-skipping transfers requires the reversal of so many fundamental tax policies, one must question whether the game is worth the candle; more importantly, one must ask whether Congress has really addressed that question.

IX. Conclusion.

As stated earlier, Treasury is to be commended for its effort to simplify the generation-skipping tax. However, its proposal includes changes which raise very fundamental questions about the nature and application of our transfer tax system. Moreover, despite these efforts, many of the existing problems of Chapter 13 continue as part of the new proposal: the ascertainment of generation assignment, the identification of the grantor in the case of multiple grantors, the determination of a "present" interest, the determination of a "nominal" interest, the application of postponement rules, the identification of "trust equivalents" and the application of the "separate share" rule, to mention but a few. Consequently, many of the old criticisms remain. This being the case, the $1,000,000 exemption may mean only that a bad tax is applied to fewer people and that is hardly justification for its enactment.

As noted earlier, we and other organizations such as the American Law Institute are currently studying this area. Congress should permit these studies to be completed before enacting a new set of provisions which may also prove to be unfair and unworkable. While Congress and other groups grapple with these problems, there is no basis for not immediately repealing the present Chapter 13 provisions, especially in view of the Treasury's own public acknowledgment of the inadequacy of the present system, and the lack of any proposed statutory language which would make possible its enactment (even if a consensus could be reached) in the near future.

I appreciate the opportunity to appear before the Subcommittee today and to have our views heard.

Senator SYMMS. Thank you very much.

Mr. Hughes.

STATEMENT OF VESTER T. HUGHES, ESQ., PARTNER, HUGHES & HILL, DALLAS, TEX.

Mr. HUGHES. Mr. Chairman, my name is Vester Hughes. I am a tax practitioner in Dallas, Tex. Rather than stick with the text, I would like to make a few observations and then answer any questions you may have.

In the first place, I think it is clear to everyone that the present generation-skipping tax provisions do not work. You have four pages of instructions and forms to fill out with 61 line items. It is an impossible situation. It is compounded by the fact that the 1976 law is currently in full effect.

In my paper I noted that one 90-year-old lady, a client, wanted to take care of a laborer she had employed for some 30 years who had physical disabilities. In order to write the provisions not to invoke a second tax, which would have prevented her ranch from being transferred to the living great-nieces, it cost $9,200 of minimum billable time for a single codicil to her will.

I submit that that complexity is inordinate and is not in the national interest, the waste of time, energy and effort.

Senator SYMMS. How much did you say it cost?

Mr. HUGHES. $9,200 of attorney time in order to make a $50,000 bequest to a laborer who had been with her since he was a child and who had very difficult back problems.

The law is unworkable. Treasury says it is unworkable. It seems to me the only thing we can and should do at this point is to repeal it and repeal it at once. That leaves us with the question of the Treasury proposal. What, if anything, should be done?

Back in 1967, when Professor Carl Shoupe wrote his book on Federal estate and gift taxation, he stated in very candid fashion on pages 100 and 101 that the objectives of the estate and gift tax law were not at all clear. I think this is true today.

Treasury has said, for example, in its proposal, that we should have the tax which Mr. Moore has just described imposed on direct transfers. The imposition of the tax on direct transfers is in the nature of an accessions tax. I don't believe Treasury answered the Senator's question this morning very fully.

An accessions tax may be the right form of transfer tax if we are going to have one. If indeed the purpose is to avoid undue accumulations by persons who didn't earn those accumulations, then looking at the recipient may well be the way that the tax should function. But certainly the tax shouldn't function both ways.

The estate tax has traditionally been a tax that is viewed from the perspective of the transferor, not the transferee. What we have in the Treasury proposal is a combination. We have a tax from the perspective of the transferor and also from the perspective of the transferee if that transferee is in a third, fourth, or fifth generation.

I submit that the compounding of the tax that this represents is something that is new, different and should be examined very carefully. In 1976 Congress didn't see fit to go along with this. When the American Law Institute did its study that was completed in 1968 on Federal estate and gift taxation, it recommended that direct transfers not be taxed.

Perhaps if we were starting fresh and were looking at an estate tax and we were looking then at an accessions tax, some combination would be acceptable. I don't know. I don't think that we should move toward the accessions tax or, as Mr. Moore has accurately stated, more of an inheritance tax than an accessions tax, because the proposal fixes the rate by reference to the recipient. But certainly we shouldn't move in that direction without a considerable study.

In my submission I have suggested that maybe the thing to do is for Congress to suggest, both to congressional staffs and to Treasury, that there be a study, and perhaps the accessions tax should be a complete substitute for the estate tax. If so, so be it. I personally have grave reservations as to whether there should be a transfer tax, but apparently the revenue implications are such that we must have some form of transfer tax, at least for the moment.

Some of the rates that have been suggested today certainly would help that. As one of the speakers said, an economic agricultural unit cannot be transferred and enough money earned from that agricultural unit to pay for the transfer taxes in a lifetime, at least as it relates, for example, to West Texas ranches. I think that is unfortunate.

Senator SYMMS. Well, I think that what we are saying is that the rate is too high, if there is to be a tax—which philosophically I frankly think there shouldn't be one—but if the society chooses to have this form of a distribution of the wealth or whatever it is they want to call it—there was a suggestion made earlier, Mr. Hughes, and I know you have a reputation that you have had a great deal of experience in this, that a 20-percent rate should be the maximum tax. Do you think that would avoid a great deal of the costs that you referred to earlier?

Mr. HUGHES. I think it would. A lower tax rate, I suspect, would cause many individuals not to try to go to elaborate lengths to work out transfer arrangements that will—indeed, what we are talking about here—skip generations. The English kings had this problem. That is where the rule against perpetuities came from.

But the rule against perpetuities was workable: life or lives and beings plus 21 years.

So, we impose a tax every 80, 90 years. Maybe so. Maybe that kind of tax on transfer was workable. Maybe it should be. We have had, for example, some capital formation implications with respect to the current rules because property, particularly stocks and bonds, were kept in trust. They weren't sold immediately upon fluctuation in price. That gave stable investment to American business. And perhaps that was useful. I don't know.

But the objectives are not clear. Congress hasn't spoken to those objectives. Professor Shoupe lists a number of possible objectives.

But if there is going to be a restudy, and there is going to be a compounding of the tax, if there is going to be an overlay of two types of taxes, I think that this is something that Congress needs to address and then determine what the appropriate tax mechanism or vehicle is going to be, whether it be an accessions tax, whether it be an estate tax or some other form of transfer tax.

Senator SYMMS. What you are both saying, and I know that the two of you here before this committee right now are recognized as two of the people with as great experience in dealing with this question as anything, but that if we are going to change it, what we should do immediately is repeal what is not working and then start out from ground zero on this question?

Mr. HUGHES. Absolutely. There is no justification for holding up a present repeal, in my judgment, no justification whatsoever, until something new can be put in its place because I don't believe Congress, or indeed, the scholarly thinkers in the area, are at all unified in what should be the answer. I am a consultant to the American Law Institute project, and I can tell you from our first meeting, there is no unanimity on what should be in place, if anything.

Senator SYMMS. Well, we will be sure to forward your recommendations on to Treasury, which I have been working on for 2½ half years now, that we should repeal this unworkable generation-skipping tax. I guess we do things wrong around here. The way tradition is, we always let Treasury testimony first, and then they leave, and then all of you come in with all the expert statements on why the generation-skipping tax should be repealed.

So I will see that we get some of this record made available to the experts or at least the policymakers over at Treasury that continue to roadblock what appears to me like to be just the basic commonsense. That is essentially what you are saying, just pure commonsense. If you have something out there that won't work, and when you tell a story of somebody trying to give someone a $50,000 gift and pay $9,000 in legal fees, that is almost 20 percent in legal fees. It would have been simpler to just write a check and pay the fine, I guess.

Mr. HUGHES. It would have been except this laborer would have been unable to take care of his money, so it had to be put in trust so that it could be paid to the doctors for his back operation. Undoubtedly the money would have been taken from him by either unscrupulous friends or family. The whole object was to make certain that his back ailment was taken care of after this lady's death.

Senator SYMMS. I thank you both very much.

Mr. HUGHES. Thank you, Senator.

[The statement of Mr. Hughes follows:]

STATEMENT OF VESTER T. HUGHES, JR., ESQ., HUGHES & HILL, DALLAS, TEX.,

I. The Generation-Skipping Tax Should Be Repealed Immediately

The generation-skipping tax[1] was enacted as part of the Tax Reform Act of 1976. Since then, the tax has suffered universal criticism.

The Treasury Department, in its current proposal, noted six "principal problems" with the generation-skipping tax.[2]

1. The broad scope of the tax will likely result in inadvertant noncompliance.

2. The tax "is extremely complex . . . and can be a major complicating factor in advising clients."[3] This complexity is well illustrated by the failure to issue final regulations (except with respect to effective dates[4]) in the six years since enactment. Meanwhile, we witness a frightful waste of effort and squandering of resources as practitioners, without official guidance, attempt to adjust dispositions in reaction to the generation-skipping tax. For example, $9,200 of attorney time was required to draft a codicil so that a 90-year-old widow could provide a $50,000 trust fund for a faithful laborer who had served her for 39 years. Such perversions will continue until Congress repeals this unworkable law.

3. The tax is an administrative nightmare for the Internal Revenue Service. A hint of problems to come can be found by perusing the new forms. Form 706-B(1), entitled "Informational Return by Trustee for Taxable Distribution on Termination From a Generation-Skipping Trust," for example, features four pages of fine print with 61 line items. This form was five years in development.

4. The tax can be easily, but expensively, avoided. The generation-skipping tax is a statutory Rubik's Cube; tax advisors manipulate its facets at appalling expense.

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[1] The generation-skipping tax is contained in Chapter 13 of Subtitle B of the Internal Revenue Code, §§ 2601 et seq.

[2] Department of the Treasury, A Proposal to Simplify and Improve the Generation-Skipping Transfer Tax, 4-7 (April 28, 1983) (hereinafter "Treasury Proposal").

[3] Id. at 5.

[4] See Treas. Reg. § 26.2601-1. The Secretary is directed to prescribe regulations. I.R.C. § 2622.

5. Unfairness results from the complexity and ineffectiveness of the tax.

6. The tax "is not based on any logically consistent view of the Federal transfer tax system."

The Treasury has acknowledged that limited changes cannot "patch" the generation-skipping tax.[5] Yet, the tax is in full effect right now.[6] Immediate action is called for.

II. The Treasury Proposal of April 29, 1983

The objectives of the estate tax (except generation of revenue) have never been the subject of clear agreement.[7] By imposing an additional tax on direct transfers to remote generations, the Treasury Proposal manifests an objective to tax wealth once for each generation, even if that generation never had any interests in or power over that wealth. Congress has never adopted this radical view of wealth transfer taxation.[8] After an extensive study during the 1960's, the American Law Institute specifically rejected the current Treasury position and recommended that "an additional tax should not be imposed on an outright transfer, or its equivalent."[9] The existing generation-skipping tax was aimed at the enjoyment of property by intervening generations without inclusion in their estates.

In addition, the Treasury proposal is a strange hybrid of estate tax and accessions tax. Where an estate tax is concerned with the donor's estate, an accessions tax is determined by the recipient of a transfer. The Treasury proposes that Congress exact an accessions tax, in addition to the estate tax, from transfers to donees beyond the next generation. The existing generation-skipping tax, on the other hand, is an estate tax rule that members of intervening generations who hold certain interests or powers will be considered owners of the property.[10] Treasury acknowledges it proposes "a new and fundamentally different approach."[11]

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[5] See Letter from John E. Chapoton, Assistant Secretary of the Treasury, to the Honorable Steven D. Symms, April 29, 1983.

[6] See Treas. Reg. § 26.2601-1 (tax fully effective for decedents dying after 1982).

[7] See C. Shoup, Federal Estate and Gift Taxes, 100-101 (1967) (listing possible objectives).

[8] See, e.g., S. Rep. No. 938 (Part 2), 94th Cong., 2d Sess., at 21 (1976) (". . . [T]he tax would not be imposed in the case of an outright transfer from a parent to a grandchild (because the intervening generation receives no direct benefit from such a transfer).").

[9] American Law Institute, Federal Estate and Gift Taxation, 31 (1968) (hereinafter "ALI Report").

Perhaps an accessions tax would be a desirable system. In a 1968 ALI study, however, Professor Andrews reported a consensus warning:

> that the problems of an accessions tax would be in many respects quite different from those of a transferor tax; that these problems, being new and different, would require long study before any large number of people could reach a reasonable decision as to the feasibility or desirability of an accessions tax . . ..[12]

No one has carefully studied the consequences of having both an estate tax and an accessions tax. The generation-skipping tax was passed in 1976 despite substantial disagreement among the experts.[13] A double tax should not be imposed without careful study, lest we find ourselves in this same room several years from now, wondering what to try next.[14]

III. Conclusions

A. Congress should not adopt a new tax, based on an accessions concept that is alien to our wealth transfer taxation experience, without careful study. Perhaps the Treasury and Congressional staff should be directed to undertake such a study.

B. Repeal of the current generation-skipping tax, which everyone seems to agree is unworkable, should not be delayed. If Congress delays during the time required to thoroughly study any new tax, countless hours of taxpayer, practitioner, and government time will be expended on a tax that never was and, by consensus, never should have been.

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[10] Cf. I.R.C. § 2041(a)(2) (Including in the gross estate property over which decedent had a general power of appointment.)

[11] Letter from John E. Chapoton, supra note 5.

[12] ALI Report, supra note 9, at 446-47.

[13] See, e.g., Federal Estate and Gift Taxes: Hearings Before House Ways and Means Comm., 94th Cong., 2d Sess. 1332-1447 (1976). The problems of the current law may well be traceable to its hasty enactment. See Baetz, Is Repeal the Answer to This Dilemma?, 121 Trusts & Estates No. 3, at 16 (1982).

[14] In fact, the American Law Institute is currently engaged in a comprehensive study of generation-skipping transfers.

Senator SYMMS. The chair would now announce that we have about 10 witnesses left and I suppose some of you may have airplanes to catch and so forth this afternoon. So we will just stand in recess until 10 minutes after 12 and then we will go right on and complete the hearing process this morning. So we will be in recess for 5 minutes.

[Recess.]

Senator SYMMS. The next panel is Timothy Baetz, Austin Wentworth, John Wallace, and Robert Hughes. I know that Tim Baetz, you have been here many times before and I appreciate your reappearance here this morning.

I might just say for the benefit of all of us that are here in the room that I just met Mr. Gartland here from Treasury, so Treasury is represented and he assures me that they are listening very attentively to some of the expert witnesses, and the Treasury will carefully peruse this record.

So we hope that this hearing here this morning will be helpful to what will bring about what I would say is fair and equitable tax policy for this country, so that we can, in fact, get behind us one of the problems that is much more of a problem than often meets the eye. It is something that isn't talked about much in the news media, and it is easy for me to understand why it wouldn't be talked about much in the news media.

In fact, I don't talk much about the generation-skipping tax in different platforms that I get on in the country because it is so complicated that most of us simply can't understand it.

Now the thing that I think is heartening to some of us that are not experts in the field but who have the insight into the damage that it does to the economy is that even the experts from in here, people who have spent their entire lives, like Mr. Hughes and Mr. Moore who have just testified, who are regarded as expert in the field, they make it very clear that it is impossible to apply the present law and have any form of equity to come out.

I think it was Mr. Moore that made the point that the tax rate depends on who you are or who happens to do the estate planning. I think that is a very bad situation to have a tax law that is that complicated because it just simply cannot bring about fair and equitable tax policy, and it does create a great deal of cynicism by the thinking people in the country who are the opinionmakers across this land of ours. And I think that when the public becomes very cynical of the Government and tax policy, you create a situation that just adds to the underground economy, adds to bad business practices. I think that it certainly is something that is long since past the time when the day has come that it should be repealed.

Now Tim, I know you have worked on trying to repeal the generation-skipping tax since it was passed in 1976. So here we are in 1983 and I think that that is my concern about the substitute proposal that Treasury has made now. Until we can get a handle on exactly what it is Treasury wants to do, to pass something prematurely, in effect—you have been working on this for 7 years, so you have been doing it a lot longer than I have, and we still have not yet achieved it.

We have gone through two administrations now—well, three administrations, actually, since 1975, and still seem to run into the fundamental roadblock, which is the mind-set of Treasury on trying to put something into effect.

I think President Reagan made the comment once that there is nothing on this Earth that has eternal life any more than a Government agency. You might also say that all you have to do is get some little tax rule or regulation. Once passed by Congress, whether they intended it to be like it was or not, it is very hard to ever get anyone to want to come in and repeal something that has already been done. And I think no one probably more than you can speak to that effect.

So we are happy to have you all here today. We can, with a little luck, have everybody out in time that they can catch their early afternoon flights, people who are trying to return to their businesses, so that they can pay their taxes to keep the salaries paid of those people at Treasury that are blocking this effort.

So we will go right ahead now. Mr. Baetz.

STATEMENT OF W. TIMOTHY BAETZ, ESQ., McDERMOTT, WILL & EMERY, ON BEHALF OF THE ILLINOIS STATE BAR ASSOCIATION, CHICAGO, ILL.

Mr. BAETZ. Thank you, Mr. Chairman. My name is Tim Baetz. I am here today on behalf of the Illinois State Bar Association. I have appeared before this subcommittee on a number of occasions and have written in excess of 1,000 pages of text to you and to the Treasury Department on the tax on certain generation-skipping transfers. It has been no fun.

Now 7 years after the sad event, we are here again, and this time to analyze a set of Treasury proposals dated April 29 of this year. This is not the first but rather the second set of proposals with which we have had to contend.

I think first of all, it is interesting to note that the first half of the Treasury proposal is not a proposal at all. It is a ringing indictment and conviction of the current chapter 13.

Now it seems to me, and my recollection goes back over 7 years of this debate, that the only group in the United States of America opposed to the repeal of the generation-skipping tax was the U.S. Treasury Department. Four months after the tax is fully in effect, they finally admit that it is unworkable. Eighteen months after they last corresponded with you, Mr. Chairman, they admit that the tax cannot be defended in its current form.

I wish they had told you that a little bit earlier because then I suspect we might have been able at the very least during the lame-duck session to pass your moratorium, which would have spared all of us that do estate planning, the agony of going through this last 6 months. Now 7 years after the statute was enacted, we seem to have unanimity that it is not what is needed.

I think all of that places the Illinois State Bar Association in a camp with my professional colleagues this morning in begging you to have the current statute repealed as quickly as possible. But I don't want to ignore the Treasury proposals.

In the first place, I think it is noteworthy to observe that now there is a completely different thrust in what is abusive. Now direct transfers, as for example from a grandparent to a grandchild, are by Treasury deemed to be the sort of thing which deserves taxation. Mr. Woodward said it is not abusive behavior; it is a result that seems like abusive behavior which merits taxation.

This helps to confuse me still more. It makes it very difficult to respond to Treasury because at this juncture it is hard for us to know just what is it that you want to tax in this area.

If you switch from Treasury's direct transfer proposal to the other very large part of what it is telling you, you will notice it is advocating you retain the existing tax. In a number of respects, the big problems that we have raised with you are unaddressed. Who the chapter 13 grantor? Treasury doesn't think that is a problem, but I wrote 136 pages of single-spaced stuff for the American Bar that says otherwise. When is a taxable termination deemed to properly occur? Treasury doesn't address the problem. Assignment of generations? Treasury says this isn't an issue. A large part of the work that we have done for the American Bar Association says it is.

What is a nominal interest? What is a present interest? What is the separate share rule?

All of these things have to be understood by those of us who are unfortunate enough to have to work with this tax on a daily basis. All of those things are retained. But Treasury says that you shouldn't worry about that because we are only going to apply these horrible rules in the context of really wealthy folks. Well, I submit to you that I think a bad tax is no better when applied to fewer taxpayers. We are anxious to learn what you believe in that regard.

Furthermore, even the flat tax proposal, which admittedly eliminates the deemed transferor and with him, lots of problems, isn't the simple thing Treasury would have you believe. You still have to find the taxable property number against which to apply that flat tax. And that is not in every case a simple matter. There are deductions, exemptions, and credits which are framed by reference to the deemed transferor, the animal they are going to kill.

There are other things of a deduction and credit modality which are inscrutable, as for example, the charitable deduction under chapter 13 and certain expense deductions.

We think we are still a long, long way from an answer in this area. We want to help, but frankly, the Treasury makes it harder and harder because we become less and less able to tell you what the abuse is. In the meantime, we beg that the current statute be repealed immediately. Thanks.

[The statement of Mr. Baetz follows:]

STATEMENT OF W. TIMOTHY BAETZ ON BEHALF OF THE ILLINOIS STATE BAR ASSOCIATION FOR THE HEARING ON CERTAIN FEDERAL TRANSFER TAX ISSUES HELD BY THE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION OF THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE

June 27, 1983

Mr. Chairman and Members of the Subcommittee:

My name is W. Timothy Baetz, and I am here on behalf of the Illinois State Bar Association, a professional organization comprised of 26,000 attorney members. I serve on the Council of the Association's Section on Federal Taxation, and I am a partner in the Chicago law firm of McDermott, Will & Emery.

My Remarks Are Restricted to the Generation-Skipping Tax Problem

The Illinois State Bar Association realizes that you have called this hearing to obtain information on a wide range of federal transfer tax issues. However, the Association has instructed me to restrict my remarks today to the very important question of the federal tax on certain generation-skipping transfers. This is a subject about which the Association has been quite concerned for several years, and we are grateful for this opportunity to convey our views.

Long ago, the Association adopted a resolution calling for the immediate and complete repeal of Chapter 13 and related Internal Revenue Code provisions. Our representatives appeared at your June 5, 1981, and November 4, 1981, hearings to explain the reasons for this position.

On April 29 of this year, the U.S. Treasury Department offered a proposal to "simplify and improve" the generation-skipping tax. The Association has re-examined its Chapter 13 position in light of this proposal and has asked that I tell you today that the Association continues to believe that immediate and complete repeal of Chapter 13 is the best answer to the problems created by the generation-skipping tax.

The Association Wholeheartedly Supports S. 1252

The Illinois State Bar Association wishes to thank you, Mr. Chairman, and your co-sponsors for introducing S. 1252. This bill deserves immediate Congressional attention and has the Association's complete support.

Repeal the Current Chapter 13 Now

For quite some time, the dangers and inherent debilities of the current Chapter 13 have been widely acclaimed. At previous hearings, you received ample testimony on the subject from every profession that is required to deal with (or try to deal with) the generation-skipping tax. The American Bar Association, the American Bankers Association and the American Institute of Certified Public Accountants all asked you to repeal Chapter 13.

Several state and local bar associations came here to endorse repeal. A number of affected taxpayer groups likewise indicated to you that in their view repeal offered the best solution to the generation-skipping tax dilemma.

Only the U.S. Treasury Department felt otherwise. At your last hearing on the subject, David G. Glickman, then Deputy Assistant Treasury Secretary (Tax Policy), indicated quite clearly that Treasury supported neither the repeal nor the suspension of the current Chapter 13.

Convinced of the difficulties presented by the current generation-skipping tax statute, you, Mr. Chairman, quite fittingly attempted in December of last year to stay the application of the tax until the issues were resolved. We lament that your Chapter 13 "moratorium," added to the so-called "gas tax" bill, was deleted in conference. As a result of that deletion, Chapter 13 became fully operational on January 1 of this year, bringing completely into play all of the generation-skipping tax problems and concerns about which you have received so much testimony at prior hearings.

Now, Treasury offers you a proposal to "simplify and improve" Chapter 13. As the following remarks will elaborate, we have several misgivings about this proposal. But, leaving those misgivings aside for a moment, we must point out that a significant portion of the text of Treasury's proposal is not a proposal at all. Rather, it is a ringing indictment and conviction of the current Chapter 13.

Now, four months after Chapter 13 has become fully operational, Treasury finally admits that the current Chapter 13 is totally unacceptable. Now, eighteen months after Treasury's last communique to you, a communique opposing repeal or suspension of the current Chapter 13, Treasury finally concludes that there are "real problems" with the existing statute in terms of complexity, administrability, effectiveness, fairness and lack of logical consistency -- in other words, real problems with virtually every aspect of the tax! Now, almost seven years after enactment, Treasury finally concedes that the current Chapter 13 is not workable.

But, does Treasury suggest at this point that the current Chapter 13 ought to be repealed at once? Astonishingly, Treasury does not. Rather, Treasury indicates that the present statute should be repealed only when and if Treasury's new Chapter 13 proposal becomes law. Only at that time is Treasury prepared to see the current law repealed "retroactively, so that no trust will ever be subject to the provisions of that tax."

How can Treasury admit on the one hand what so many of us have been telling you for years, namely, that the current Chapter 13 is completely indefensible, and refuse on the other hand to support immediate repeal of the statute? After damning the current statute, how can Treasury justify holding its repeal hostage to the enactment of new Chapter 13 proposals?

Treasury may be convinced that its most recent proposals "fix" Chapter 13, but, as the following remarks indicate, we are not convinced. Indeed, we think the new proposals do not focus with greater accuracy upon, but rather further obscure, just what the real generation-skipping abuse (if any) is.

Can Congress in good conscience require that taxpayers and their representatives continue to labor under an unworkable tax statute while Treasury's new proposals are debated and refined and recast and perfected? We think that it is extremely unfair to ask so much. Treasury offered different proposals to you eighteen months ago, and those proposals were severely criticized. There seems to be little reason to believe that less time will be required with respect to the current proposals. In this regard, one must bear in mind that much of the current statute would be retained in Treasury's new proposals, and Treasury knows better than anyone else that it has not been possible to develop satisfactory regulatory underpinning for the current statute in spite of seven years' effort.

We can only conclude that substantial additional time is required if the generation-skipping issue is to be properly understood and addressed. In the meantime, it is extremely unfair to leave the current Chapter 13 in place to bedevil and befuddle taxpayers and tax collectors alike. The existing Chapter 13 does not deserve a place in our federal transfer tax system and should be repealed at once.

Preliminary Reaction to Treasury's New Proposals

This response to the April 29, 1983, Treasury proposals is necessarily preliminary in nature. The proposals themselves have been advanced only in a general fashion and are not accompanied by any recommendations regarding statutory language. Unquestionably, a great deal more could be said (and, in all probability, additional troublesome issues could be identified) if and when Treasury decides to offer proposed statutory provisions for public consideration.

On the policy level, it is fair to say that Treasury's new proposals create increased confusion regarding just what sorts of "generation-skipping" activity ought to be viewed as constituting abusive, and, therefore, properly taxable, behavior. It is with great surprise that we now see that Treasury considers any outright transfer to a recipient two or more generations younger than the transferor as a proper generation-skipping taxable event. Treasury insists that taxing such direct transfers is "essential" in order to lend "logical consistency" to Chapter 13.

We wonder whether Congress shares Treasury's view. If a transfer from a grandparent directly to his or her grandchild constitutes abusive "generation-skipping" conduct, we would like to think that the matter is and always has been so fundamental and in such plain view as to have deserved attention in the original Chapter 13 enacted in 1976. Yet, neither in Chapter 13 nor in its underlying legislative history is there the slightest indication that Congress considers direct transfers of this type to be fit for generation-skipping taxation. On the contrary, there is every indication that only when transferred property is held outside the purview of the federal estate and gift taxes is it proper even to consider taxation under Chapter 13. Direct transfers are not outside such purview even for an instant, the transferor being required to cope with estate or gift taxation up to the moment of transfer and the transferee being required so to cope thereafter. We feel certain that Congress will want to think long and hard before swinging 180 degress to embrace the new Treasury position on this matter.

Still on the policy level, we see another possible problem with Treasury's direct transfer proposal. When a trust is created for the benefit of the grantor's grandchildren and more remote descendents, Treasury advocates generation-skipping taxation at the time of trust creation on the same "net-now" basis that Treasury would apply in the context of an outright transfer from a grandparent to a grandchild. Treasury goes on to say that in this circumstance "the corpus of that trust cannot be subjected to the GST tax on more than one occasion." This result would seem to encourage the establishment of long-term, multi-generational trusts of the type just described, and it is hard to square this result with the Congressional view expressed when Chapter 13 was enacted "that the tax laws should be neutral and that there should be no tax advantage available in setting up trusts."

In circumstances where the direct transfer rules just discussed do not apply, Treasury is advocating that many of the current Chapter 13 rules be retained. Treasury believes that its proposals for a large general exemption, a flat tax and the elimination of powers as Chapter 13 "interests" will cure most of the problems associated wtih these rules. We believe otherwise.

Chapter 13 "grantor" identification would still be required under the Treasury proposal, and failure to determine this "grantor" makes it impossible to apply Chapter 13. Two years ago, I wrote a 136-page commentary to Treasury on behalf of the American Bar Association's Section of Taxation, and, in that commentary at pages 9-20, I addressed several troublesome issues relating to

Chapter 13 "grantor" identification, issues which are still unresolved (and, perhaps, unresolvable). Especially in the contexts of entity-grantors and multiple grantors, Chapter 13 promises to continue to be a problem even if Treasury's new proposals are adopted.

The generation assignment rules would be retained in Treasury's new proposal. Treasury says that these are "a reasonable and workable set of rules." The ABA commentary cited above suggests just the opposite. At pages 21-29 of that commentary, several important and as yet unresolved problems in this area are discussed, including the proper application of the generation assignment rules in the contexts of stepchildren and their descendants, generation-switching, multiple generation assignment and entity-beneficiaries. These problems would continue to plague taxpayer and government alike even after adoption of Treasury's new proposals.

Certain of the so-called "postponement rules" would continue to apply even if Treasury's new proposal were adopted. The aforementioned ABA commentary contains ample support (at pp.67-87) for the proposition that these rules have been wrongly cast in the statute. They have clearly defied regulatory interpretation. Even with Treasury's new proposals, these rules would continue to cause confusion.

Similar problems would continue with Chapter 13 "interests." The definition of the fundamental term "interest" is incomplete and ambiguous in both the statute and the underlying regulations, causing problems particularly in the context of assignments and disclaimers. See pp. 111-113 of the aforementioned ABA commentary. The Treasury proposal offers no enlightenment in the matter.

The "separate share" rule would continue intact. No one understands the purposes to be served by this rule, and its effect is in no way clarified by Treasury's new proposal. See pp. 115-123 of the aforementioned ABA commentary.

Treasury says that under its new proposal the "trust equivalent" concept "would no longer be relevant." We do not understand how this can be so. Any annuity under which the purchaser's children and other descendants are annuitants would become a perfect tax avoidance device if Treasury is correct. We think Congess would be troubled by such a loophole, although we are also mindful that retention of the "trust equivalent" concept would require that substantial attention be paid to the many problems in this area about which you have heard much testimony at previous hearings. See, in this regard, pp. 30-43 of the aforementioned ABA commentary.

Treasury says little in its proposal about Chapter 13's interaction with related Code provisions, and yet this is an important subject about which there continues to be great confusion. Treasury has been unable to develop any regulatory guidance regarding Chapter 13's interaction with IRC §303 (d), dealing with distributions in redemption of stock to pay generation-skipping tax, or its interaction with IRC §691 (c)(3), dealing with the income tax deduction for income in respect of a decedent involved in a generation-skipping transfer.

Treasury's proposal does contain a statement with respect to credit for tax on prior transfers, but we find hard to fathom from this statement just what sort of credit system is being advocated when transfer taxes of the same or different variety follow one upon another in close succession. Our preliminary reaction, however, is that Treasury's ideas in this regard represent anything but the "simplification" that Treasury is telling you is embodied in its proposal.

Treasury is in effect saying to you that the problems just mentioned, problems which are in the current statute and would be carried over, as well as other problems of the same ilk, which could have been mentioned but for sake of brevity have not been, should not trouble you or us in light of the proposed $1,000,000 general exemption. After all, one would have to be "wealthy" in order to be required to confront these problems; most taxpayers will not have to worry about them. But is a bad tax better when applied to fewer taxpayers? We think not, and we are anxious to learn what you believe.

In this regard, I hope you will pardon our voicing skepticism about the staying power of the $1,000,000 exemption proposal. In 1976, we saw the Chapter 13 "grandchild exclusion" start out as a $1,000,000 proposal and end up as a $250,000 statutory provision. In 1982, we saw the IRC §2039(g) employment benefit exemption start out as a $500,000 proposal and end up as a $100,000 statutory provision. Obviously, any similar diminution of this proposed $1,000,000 general exemption would seriously impair whatever vitality one might otherwise ascribe to Treasury's position in this matter.

In view of its proposed general exemption, Treasury seeks repeal of the "grandchild exclusion." Treasury states as a big benefit to be derived from such repeal the elimination of the "need for keeping records concerning the use of the ... exclusion." What Treasury does not tell you is that the proposed general exemption carries its own new record-keeping headaches. In addition, the elective nature of the proposed general exemption offers all sorts of new complications, both in terms of information attainment and information retention. The process will be anything but "simple" in spite of what Treasury may have you believe.

Even the Treasury's flat tax proposal leaves important problems unresolved. Admittedly, the flat tax eliminates the need for a Chapter 13 "deemed transferor," and this would clearly improve the Chapter 13 tax payment process. But a number of Chapter 13 deductions, credits and adjustments are keyed to the deemed transferor. See IRC §§2602(c)(3), (c)(4), (c)(5)(A), (c)(5)(C), (d) and (e). If the deemed transferor vanishes, what happens to these items? They are important features of the Chapter 13 system, and yet, Treasury's proposal is silent regarding whether they will be abandoned or recast.

In addition, certain Chapter 13 deductions have to date defied understanding, and, presumably, Treasury advocates retention of these items. There is, for example, a charitable deduction the perimeters of which cannot be articulated. See IRC §2602(c)(2) and the list of imponderables about this deduction appearing in Stephens and Calfee, "Skip to M'Loo," 32 Tax L. Rev. 466-470 (1977). There are also expense deductions framed inscrutably by reference to federal estate and income tax rules that are inapposite to generation-skipping transfer circumstances. See IRC §§2602(c)(5)(B)(i) and (ii) and Stephens and Calfee, op. cit., at 474-475.

In short, one must derive the same taxable property number as is now required before one can apply Treasury's proposed flat tax rate. This derivation, for the reasons just mentioned, may not be as "simple" as Treasury suggests.

Finally, Treasury indicates that its new proposal "would apply only prospectively, with a one-year transition period for transfers at death in order to allow for people to change their wills if necessary." A six-year transition period has proved inadequate under the current Chapter 13, and enough of the current system is incorporated into Treasury's new proposal to create suspicion that one year of adjustment grace cannot possibly be enough to accomodate changing from old to new.

One also wonders what the implications of dying during the one-year transitional period will be. Treasury's proposal carries a suggestion that in such circumstances neither the old nor the new generation-skipping tax will apply. If this is so, why should the existing Chapter 13 be any more applicable today than during the one-year transition period?

Summary

The foregoing indicates to us that the generation-skipping tax dilemma is far from over. Whether Treasury's new proposals can be revised or refined in such a way as to make them preferable to repeal is difficult to say. In any event, the process will take a long time, and, in the meantime, the current Chapter 13, now thoroughly discredited even by the Treasury Department, deserves immediate repeal.

Senator SYMMS. Thank you very much for a very excellent statement. I think that your point that should be reemphasized is that if it is a bad tax law, it doesn't matter how many people it applies to.

We have just witnessed in the passage of the 1982 TEFRA Act a portion of that act included withholding of savings interest and dividends. Many of us thought it was a bad tax when it was passed but for many reasons it became part of a bigger revenue-raising bill. And where there were so many people affected by it, we actually witnessed Congress doing the right thing, and that was to respond to the American people. We had some 70,000 pieces of correspondence just from the State of Idaho, which I think is remarkable in itself when you think there are less than 1 million people that live in the State of Idaho and 70,000 people actually corresponded from my State to my office asking for the repeal of bank withholding.

So the Congress responded, I think quite properly so, and bank withholding has been repealed. But in this particular case you don't have the ability to generate public popular support for this kind of a situation.

It is kind of like the so-called windfall profits tax, which is really an excise tax on the wellhead on oil production. If Congress decided they should have raised that revenue from oil, it would have been a lot more equitable to apply it to the gas pump, but there are a lot more people buying gas than there are that own oil wells. So it was a lot easier to put the tax on the fewer number of people, and the American way has always been to tax somebody else but don't tax me. It ended up that we have a very discriminatory tax against production again instead of a tax on consumption.

I think that you make an excellent point and I hope that we will be able to do something on it and I hear the sincerity of your appeal to us and I hope that we can be successful because I think that the sincerity of your appeal is not only sincere, but it is appropriate, it would be fair and it just needs to be done.

Your extensive work that you have done on this subject, the extensive amount of time and effort you have put into it, is appreciated by many of us and we hope that it won't be in vain.

Now we will hear from Austin Wentworth on behalf of the American Bankers Association.

STATEMENT OF AUSTIN N. WENTWORTH II, VICE PRESIDENT, FIRST NATIONAL BANK, BOSTON, MASS., AND A MEMBER OF THE TRUST TAXATION COMMITTEE, AMERICAN BANKERS ASSOCIATION, ACCOMPANIED BY J. STODDARD HAYES, VICE PRESIDENT, WILMINGTON TRUST CO., WILMINGTON, DEL.

Mr. WENTWORTH. Mr. Chairman, I am Austin Wentworth, vice president of the First National Bank of Boston and a member of the taxation committee of the trust division of the American Bankers Association. I have with me today J. Stoddard Hayes, vice president of the Wilmington Trust Co. in Wilmington, Del., who is also a member of the taxation committee.

We appreciate the opportunity to present our views on pending legislation to repeal the generation-skipping transfer tax, S. 1252.

This is not the first time that the ABA has appeared before this committee to present our views on generation-skipping transfer taxation. We were here in May 1981 and again in November 1981, urging repeal of this tax.

From our perspective, the tax is too complex. Treasury, in its proposal, makes the following comments on the complexity of the statute. They say it is extremely complex, and the cost of this complexity is borne in part by the taxpayers through increased fees for estate planning, as we have heard this morning, in part by the Government to the extent that these fees are taken as income tax deductions, and in part by practitioners to the extent that extra time trying to master chapter 13 cannot be billed to clients.

We agree with the Treasury Department's assessment of the complexity of chapter 13. After 6½ years on the books, the experts are still unable to fully comprehend the intricacies of the tax, and it is totally unrealistic to assume that the general practitioner will be able to advise clients as to what their obligations are under chapter 13.

I have spent a number of hours and months traveling around the countryside conducting seminars, teaching individuals who work in the professional community and in bank tax departments how to deal with the law and prepare these returns. Even after a seminar, there are questions that still remain unanswered. The best answers we can give are we are waiting for the Treasury regulations. As you know, those regulations have not come out and it looks to us like they are not forthcoming. The Treasury instead has spent its time coming up with the proposal.

The second item with respect to the current law is the fact that it is practically unadministerable. Treasury makes the comments that chapter 13 is unduly complex from an administrative standpoint, that every person alive on or after June 11, 1976 is potentially a deemed transferor and thus, the IRS theoretically must stand ready to provide estate and gift tax information regarding every one of these individuals, regardless of whether or not their estates have ever filed a Federal or State gift tax return.

Treasury admits in its proposal that it is nearly impossible for it to do that, and the amount of time and effort and money to be expended to set up such a retrieval system is extremely costly and difficult to operate and maintain. We again agree with the Treasury Department's assessment of the current law and say that it is practically unadministerable.

The costs to the Government and the expense to trustees and taxpayers are certainly going to far exceed revenues for many years to come.

After 6½ years of this workable tax, we feel as you do, as noted in your statements earlier today: It is time that this law was repealed, and repealed immediately. We do not subscribe to the Treasury's statements that the repeal of this law should be held hostage to the Treasury's proposal. We feel that the Treasury's proposal should be studied and studied carefully and the urgency to repeal the current law should in no way interfere with that study.

[The statement of Mr. Wentworth follows:]

TESTIMONY
OF
AUSTIN N. WENTWORTH, II
ON BEHALF OF
AMERICAN BANKERS ASSOCIATION
ON
REPEAL OF THE GENERATION-SKIPPING TRANSFER TAX
BEFORE THE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
COMMITTEE ON FINANCE
UNITED STATES SENATE

JUNE 27, 1983

Mr. Chairman and Members of the Subcommittee: I am Austin N. Wentworth, II, Vice-President of the First National Bank of Boston, Massachusetts, and a member of the Taxation Committee of the Trust Division of the American Bankers Association.

The American Bankers Association (ABA) is a trade asssociation composed of more than 13,000 banks - over 90 percent of the nation's full service banks. Approximately 4,000 of these institutions are authorized to serve their customers as trustees and executors. The Association has a long involvement in the federal estate and gift tax area because of our members' experience in the planning and administration of customers' estates. We appreciate the opportunity to present our views on pending legislation to repeal the generation-skipping transfer tax, S. 1252.

This is not the first time the ABA has appeared before this Committee to present its views on the generation-skipping tax, embodied in Chapter 13 of the Code. In our testimony of May 1, 1981 and November 4, 1981 before this panel we urged repeal of this tax. We believe the tax on generation-skipping transfers enacted as Chapter 13 of the Internal Revenue Code should be repealed because it is unworkable. The statute is too complex to be understood except by a very few experts in the field of taxation and is impossible to administer.

The Treasury Department submitted to the Chairman of this Subcommittee on April 29, 1983 a proposal to simplify and improve the generation-skipping transfer tax. The Treasury's proposal makes the following comments on the complexity of this statute. "... Chapter 13 is extremely complex. It has no fewer than thirteen defined terms which fit into an intricate pattern of rules and exceptions. The tax is difficult to understand, even for tax practitioners who specialize in estate planning, and can be a major complicating factor in advising clients.

The cost of this complexity is borne in part by taxpayers, through increased fees for estate planning; in part by the Government, to the extent these fees are taken as income tax deduction; and in part by practitioners, to the extent the extra time spent mastering Chapter 13 cannot be billed to clients."

We agree with the Treasury Department's assessment of the complexity of Chapter 13. If after six and one-half years on the books, the experts are unable to fully comprehend the intricacies of the tax, it is totally unrealistic to assume that the general practitioner will be able to advise clients of their obligations under Chapter 13. Non-compliance with the generation-skipping tax will inevitably be the result. Since most estate planning experts do not fully understand the tax, non-compliance from sheer ignorance will occur in a clear majority of cases. For example, the untimely death of a trust beneficiary can convert an ordinary nongeneration-skipping testamentary family trust into a generation-skipping trust subject to tax when the result was neither intended nor could have been reasonably anticipated at the time the trust was created.

The complexity of this statute is further evidenced by the fact that the Treasury was empowered by Congress to "legislate by regulation" no less than eight times under the statute, and the IRS has failed to publish final regulations covering anything except the effective date and transition rules. The proposed definitional rules that have been issued are simply inadequate. They fail to provide needed guidance on a number of issues, the answers to which are required to properly draft even the commonest types of trusts. Unlike the estate tax, the mere recognition of taxable events in the generation-skipping tax context is difficult and may frequently be missed. For example, the death or resignation of a trustee or power holder may be a taxable termination even if such individual is not actively involved in the trust's administration. Likewise there are events and facts having generation-skipping consequences which may be beyond a trustee's control or knowledge. To illustrate, deemed transferors will frequently not be clients of the trustee or his attorney so that the trustee will not be knowledgeable about the deemed transferor's affairs.

The Treasury's proposal makes the following comments on the administrability of the statute. "Chapter 13 is also unduly complex from an administrative standpoint. Every person alive on or after June 11, 1976 is potentially a deemed transferor. Thus, the Internal Revenue Service theoretically must stand ready to provide estate and gift tax information regarding every one of these individuals (including any unused portion of their unified credits), regardless of whether they or their estates have ever filed a federal gift or estate tax return. Given the fact that the estate of a decedent dying after 1986 will not be required to file an estate tax return unless the decedent's gross estate and cumulative taxable gifts exceed $600,000, it is likely that the Service will be unable to determine the amount of the unused unified credit of the deemed transferor in a large number of cases. Even assuming the necessary data concerning the unused unified credit and other matters could be obtained, the information storage and retrieval system required would be extremely costly to maintain and operate."

We agree with the Treasury Department's assessment of the administrability of Chapter 13. In contrast to the costs that will be incurred in the administration of the tax the revenue impact is _de minimis_. According to the staff of the Joint Committee on Taxation, the generation-skipping tax was projected to have negligible revenue in its early years and to produce only $400 million of revenue in its twentieth year (1996). This figure has been reduced by the increase in the unified credit which may be used against the generation-skipping tax to the extent not used by the deemed transferor's own estate. The costs to the government and the expense to trustees and the taxpayers will certainly far exceed revenues for many years to come.

Chapter 13 is unworkable. The statute is impossibly complex and extremely costly to administer. After six and one-half years the Treasury Department has apparently abandoned its efforts to write regulations clarifying the statute and admits that the IRS may not be able to supply the necessary information to taxpayers in order for them to calculate the correct tax due. The American Bankers Association supports S. 1252 and urges the immediate repeal of Chapter 13.

Senator SYMMS. Thank you very much. I think the one point I would like to emphasize right now is in your page 2, in the second paragraph, you make the statement, and I will just quote from it, that:

> The cost of this complexity is borne in part by the taxpayers through increased fees for estate planning, in part by the Government to the extent that these fees are taken as income tax deductions, and in part by the practitioners to the extent that the extra time spent mastering chapter 13 cannot be billed to its clients.

In view of the fact that the Federal Government has yet to raise any appreciable revenue from generation-skipping tax, I wonder how much it is costing them in the deductions that high-income people take trying to plan this. I think you make a point that often goes unnoticed and I appreciate that.

The next witness is John Wallace, the estate and gift tax committee from the American College of Probate Counsel. John, you have been here before and I know you have worked very closely with Tim Baetz on this question. We appreciate your continued interest.

I might just ask you the question before you start, do you suppose that the generation-skipping tax has been a net loser in terms of dollars of revenue to the Federal Treasury?

STATEMENT OF JOHN A. WALLACE, CHAIRMAN, ESTATE AND GIFT TAX COMMITTEE, AMERICAN COLLEGE OF PROBATE COUNSEL, ATLANTA, GA.

Mr. WALLACE. Well, I understand that there have been about 200 generation-skipping tax returns filed, Mr. Chairman. I don't know whether any tax has been paid, but I do know that a lot of fees have been paid, and none of it very happily, I might add.

Senator **Symms**. I might also say that those fees are normally tax deductible by people who are in the 50-percent income tax bracket.

Mr. **Wallace**. Absolutely.

Senator **Symms**. So if we estimated how much that was——

Mr. **Wallace**. I would doubt that this has been a cost-effective tax.

Senator **Symms**. It is probably costing Treasury money. If they would repeal it, I don't know as it would balance the national debt, but——

Mr. **Wallace**. This tax is a modest step in the wrong direction, Mr. Chairman.

Mr. Chairman, I am delighted to be back before this subcommittee once again representing the American College of Probate Counsel, which is an organization of approximately 2,500 skilled practitioners in the trust and estates area. I think I can say in truth that each of our members speaks for the concerns of maybe 100 or so clients with whom they have discussed this problem. So we are really talking for hundreds of thousands of individuals before you today.

We are again here in support of your bill to repeal the generation-skipping transfer tax, now S. 1252. The college has been formally in this position since the spring of 1981. Approximately 4½ years after this tax was enacted, following a number of efforts to educate ourselves and others, the college reached the conclusion that this was an unworkable tax and began formally to support repeal.

Since that time, Treasury has been in a posture of stonewalling repeal, saying that you could work within the present generation-skipping transfer tax. They started out with some proposals in November 1981, and have refurbished those and added to them with proposals in April of this year, almost 18 months later.

In the meanwhile, all moratoria have run out and we are now having to draft and attempt to advise with clients under a concededly unworkable law. It simply is not right.

We also join with others here today who have said that repeal of this law should not be held hostage, and that is a good term, to a substitute tax. There is no solution in sight at this point. The Treasury proposals are just that—proposals and not statutory language. They may or may not be steps in the right direction.

There are research projects underway at this time studying two points. One, is there a problem in the first place? And two, if there is a problem, what is the best solution to it? We learned in law school, Mr. Chairman, that there wasn't a legal remedy for every wrong, and there is not a cost-effective tax for every problem. This may just be one of those areas.

In any event, we plead for repeal without the necessity for a substitute tax. Consider this, Mr. Chairman. If you repeal this tax without a substitute, the shoe then goes painfully to the other foot. If Treasury feels this is a problem, then they will get underway with a solution very quickly. But if you say, well, we are not going to repeal this tax now because we want to wait for a substitute tax, there is an incentive for delay on the part of Treasury because some tax is in effect, even though it is unworkable.

That is simply, in my judgment, wrong way thinking. So we ask for repeal now without a substitute tax. And we will pledge to you, to Treasury, and to any other group that we will assist them in a careful study of the twin questions of whether there is a problem in the first place and if so, what is the right tax. We should not pass laws in a hurry. Those who fail to heed the mistakes of 1976 are bound to repeat them in 1983 or 1984.

Finally, Mr. Chairman, we have testified previously on several areas in the estate tax deferral field. We think that interest rates under that provision, just as the young man from Yuma, Ariz., said to you, ought to be examined carefully. Whether they should be linked with the interest rate charged on underpayments and overpayments of taxes generally is a real question mark in my mind. The test of what is a closely held business should be reexamined, and there also should be some judicial forum to resolve the number of disputes that arise under that provision. There is no judicial forum to resolve those problems at this point.

Finally, we would applaud your efforts and those of your colleagues who have sponsored Senate Resolution 126. Let's not drift back to where we were prior to 1976.

Thank you, sir.

[The statement of Mr. Wallace follows:]

TESTIMONY OF JOHN A. WALLACE ON BEHALF OF THE AMERICAN COLLEGE OF PROBATE COUNSEL IN HEARINGS ON S. 1252 AND OTHER TAX PROPOSALS BEFORE THE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION SENATE FINANCE COMMITTEE UNITED STATES SENATE

June 27, 1983

This statement has been prepared by the Estate and Gift Tax Committee of the American College of Probate Counsel (the "College"), and the positions presented here have been specifically approved either by the Board of Regents or the Executive Committee of the Board of Regents of the College and are submitted at the express direction of the President of the College, George H. Nofer, Esq. of Philadelphia, Pennsylvania. The membership of the Board of Regents and the Estate and Gift Tax Committee of the College is listed on Exhibit A attached to this statement.

The College is grateful for being given the opportunity to appear before this distinguished Subcommittee to express the views of our membership (which is composed of more than 2450 lawyers who specialize in the practice of trusts and estates law and related tax matters) concerning S. 1252, a bill that would repeal the generation-skipping transfer tax, and other proposals. The improvement and reform of probate laws and procedures, with the ultimate goal of simplifying to the maximum extent possible the disposition of property and the administration of estates in this country, has been a major and continuing effort of the College from the date it was first organized over 35 years ago. There is no doubt that our estate and gift tax laws represent the most complex and expensive aspect of our system of property disposition, and we welcome and accept once again the challenge of working with the 98th Congress to find additional ways for improving and simplifying these laws.

1. Generation-Skipping Tax Repeal

S. 1252 amends the Internal Revenue Code of 1954 to repeal the generation-skipping transfer tax. This repeal should be retroactive to the date of enactment of this tax.

Chapter 13 of the Internal Revenue Code of 1954, which contains the provisions for taxing certain generation-skipping transfers in trust, was enacted as a part of the Tax Reform Act of 1976. It is fair to say that the Chapter 13 proposals were not reviewed prior to enactment by outside professional groups, such as the American College of Probate Counsel, and that they received little, if any, attention on the part of Congress at the time of enactment. In fact, the enactment of the generation-skipping tax provisions, as well as much of the Tax Reform Act of 1976 that touched on the estate and gift tax area, came as a complete shock to taxpayers and most professionals who work in this area of the law.

Not surprisingly, Chapter 13 has been a complete failure. The complexity of the tax is such that it has been universally criticized by outside professional groups, and the Treasury and the Internal Revenue Service have been hard pressed to issue interpretative regulations and tax returns to implement the tax. Lack of interpretative regulations is particularly troublesome with respect to Chapter 13, since the implementation of the tax was delegated to the regulatory process in no less than eight separate areas. See generally, Wentworth and McKenzie, "The Treasury's New Proposal on Generation Skipping", 122 Trusts & Estates 35 (June 1983). The adverse impact of Chapter 13 on taxpayers was illustrated by the need for the lengthy transition period granted revocable trusts and wills in existence, first on April 30, 1976 and later on June 11, 1976, "protecting" transfers under those instruments for a period of five years so long as the relevant document was not changed in a manner that would increase the amount of any generation-skipping transfer. This transition period was extended at the end of 1981 for an additional year, with the result that taxpayers and their advisors struggled for a period of more than six years to preserve generation-skipping transfers under pre-existing revocable trusts and wills from the application of the tax. The regulations published by the Treasury and the Internal Revenue Service implementing this transitional rule (one of the few areas where interpretative regulations, even in proposed form, have been issued since the law was first enacted) denied transitional rule protection on a number of very technical bases, a circumstance that further heightened practitioners' concerns about the complexity of Chapter 13 and the manner in which it would be interpreted in forthcoming regulations and audits. In the meanwhile, affected taxpayers executed codicil after codicil in an effort to stay within the transitional rule. This whole process was an unsubtle and continuing reminder of the complexity of this new tax and the manner in which it would intrude upon property disposition arrangements within the family.

2. The Case for Repeal

Over two years ago the College reached the position that Chapter 13 was unworkable. The College, therefore, called for repeal of the current generation-skipping transfer tax and urged that position upon this Subcommittee in hearings that took place on June 5, 1981.

This position was developed after members of the College had spent numerous hours learning the intricacies of Chapter 13 and, in many instances, attempting to educate other tax professionals about Chapter 13 in seminars that took place both within and without the College. This learning process convinced the College that the current tax should be repealed and that a highly qualified study group should be formed to examine the twin questions of whether there was a need for the tax in the first place, and, only if that question were answered in the affirmative, what sort of tax should apply in this area. The College recommended that the membership of this study group include several skilled experts who practice law privately in the estate planning field.

The College continues in its conviction that the present generation-skipping transfer tax is both incomprehensible and unworkable. It is noteworthy that this position has the concurrence of the American Bar Association, the American Bankers Association, and the American Institute of Certified Public Accountants. More to the point, the recently promulgated Treasury proposals to simplify Chapter 13 acknowledge that the present generation-skipping tax is a failure on numerous grounds relating to its scope, complexity, administrative difficulties, inequalities in application, ineffectiveness and lack of logical consistency. As a

result, the Treasury has supported a repeal of the existing generation-skipping tax on a retroactive basis in these proposals. In fact, the only difference between the Treasury and the College (and the other professional organizations just mentioned) on the repeal issue is Treasury's insistence that repeal should not occur until some substitute tax has taken the place of Chapter 13. The College objects strongly to this effort to hold repeal of Chapter 13 hostage to the passage of some substitute tax. Chapter 13, with all of its acknowledged flaws, is currently applicable. Taxpayers and their advisors have no choice but to attempt to plan estates and draft instruments in accordance with an incomprehensible law. The result, as might be expected, is confusion, consternation and frustration for all concerned. On a broader prospective, the implications arising from this situation for a tax system that is dependent upon self-governance are ominous. Moreover, the Treasury's insistence that repeal of Chapter 13 be conditioned upon the passage of another tax requires the development of a substitute tax under the same type of pressure conditions that surrounded the enactment of Chapter 13 in the first place. The College submits that this approach is a blueprint for disaster and rejects the idea that repeal of Chapter 13, a concept that has universal support, should be dependent upon the enactment of some substitute tax proposal.

3. The New Treasury Proposal

The criticisms leveled at Chapter 13 by the April 29, 1983 proposal of the Treasury to simplify and improve the generation-skipping transfer tax synthesize the objections leveled at Chapter 13 by the College and other professional groups for a number of years. Carried to their logical conclusion, these objections, now endorsed by Treasury, lead to a judgment that Chapter 13 should be repealed. The Treasury does not disagree with this judgment, but differs from the College and the other professional organizations supporting repeal by its insistance that repeal be conditioned on the simultaneous enactment of a substitute tax. The College objects to this linkage between repeal and a new tax on two principal grounds. First, the substitute tax concept assumes that generation-skipping transfers constitute a problem of such serious proportions that an additional tax must be immediately imposed to protect the integrity of our present transfer tax system. The College feels that this issue should be debated and that the data used to support this conclusion should be subjected to careful and considered analysis. The revenue estimates connected with Chapter 13 do not support the perception that generation-skipping is an abuse requiring hasty legislative action. Neither, apparently did generation-skipping transfers undermine the transfer tax for the many years it existed prior to 1976. The second objection of the College to the repeal and substitution stance of the Treasury arises from the fact that the new Treasury proposal is just what it says it is, namely, a proposal rather than a full statutory substitute. It is impossible to assess the new Treasury position fully until this proposal is converted into statutory language. This will obviously take a considerable amount of time and effort, and the process of completing the task is obviously subject to the Treasury's schedule and priorities. Clearly, past performance leaves little room for optimism on this timing point. Moreover, while the new Treasury proposal represents some constructive thinking on various problems that have plagued Chapter 13, the proposal also expands the reach of the tax on generation-skipping transfers considerably by taxing both direct transfers and income distributed from generation-skipping trusts. Furthermore, the flat tax that Treasury proposes to add to the regular transfer tax duties on generation-skipping transfers can produce an overall tax burden that many would label confiscatory. In addition, there are a number of technical issues raised by the Treasury's new proposal that are not dealt with in its technical explanation. These issues relate to the calculation of the tax, the use of credits, the handling of the exemption election and the availability of tax relief rules; these omissions underscore the fact that the Treasury proposal is a discussion draft rather than a fully integrated statutory proposal. It would be a mistake to assume that the Treasury proposal represents a substitute generation-skipping tax or that it even signals the likelihood that a substitute tax for Chapter 13 can be developed in the reasonably near future. The Treasury proposal represents several tentative steps that may or may not be in the right direction.

4. Other Studies

At this moment there is underway at the American Law Institute a federal estate and gift tax project to study generation-skipping transfers. The Reporter for this study is Harry L. Gutman, a professor at the University of Virginia School of Law, and the Associate Reporter is Joseph Kartiganer, Esq. of White & Case in New York City. A distinguished panel of Consultants is available to assist the Reporter and Associate Reporter with this project. In addition, the Tax Section and the Section of Real Property, Probate & Trust Law of the American Bar Association have named liaisons to the project, as has the College. Projects of this type traditionally pursue a broad inquiry into underlying problems and potential solutions, and this study should be no exception. Quite frankly, it would be a mistake for Congress to attempt to identify the existence of a generation-skipping problem or the viable solutions to any problem that might exist in this area without the benefit of the conclusions and scholarly thought that this study can be expected to provide on both issues. While the American Law Institute study can be expected to proceed at a brisk pace, it will more than likely be a year or more before final conclusions are reached and approved by the Institute. During this time the Treasury proposal will receive careful study by scholars and tax practitioners, all of which should provide helpful insight into the advantages and disadvantages of the positions urged by Treasury at this time. The essential point is that Chapter 13 should be repealed while these efforts are taking place because of the universal consensus that the law is unworkable and the inequity involved in forcing taxpayers and their advisors to operate under a system that no one understands and no one expects to be enforced in its present form. Thereafter, a reasonable time should elapse while the entire question of generation-skipping transfers and their role in our transfer tax system are studied. It would be tragic to hold the repeal of Chapter 13 hostage to an immediate statutory solution that would be conceived and implemented in the same type of pressure cooker that produced the mistakes enacted in 1976.

5. Other Proposals

S. 1250, another legislative proposal pending before this Subcommittee, would amend the Internal Revenue Code of 1954 to repeal the estate and gift taxes. On June 5, 1981 the College recommended that the unified credit for estate and gift taxes be increased substantially if the fundamental purposes of our estate and gift tax laws are to be served. Substantially increased unified credits effectively repeal the federal estate and gift taxes for smaller and medium sized estates, and also produce a number of collateral tax and nontax benefits that are highly desirable. For this reason the College favors continuous review of the appropriate level for the unified transfer tax credit and recommends that this approach be adopted rather than a wholesale repeal of our present transfer tax laws. Another legislative proposal currently before this Subcommittee, S. 1251, was the subject of testimony by the College in hearings before this Subcommittee on May 27, 1982. The College again urges that a number of issues relating to Section 6166 of the Internal Revenue Code of 1954 be reexamined, particularly the rate and manner of charging interest on deferred estate tax payments, the use of a marketability test to define business interests that qualify for elective estate tax deferral, and the enactment of some form of judicial review to settle disputes between taxpayers and the Internal Revenue Service in connection with estate tax deferral issues. The College respectfully calls the attention of this Subcommittee to the written position on these points previously filed on May 27, 1982, which the College again submits for consideration at this time.

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Senator SYMMS. Thank you very much, Mr. Wallace, for a very excellent statement. Your entire statement, along with all other statements, will be part of the record. I think it is particularly noteworthy to note the supportive people who are listed with your statement, as is the case with many of the other statements that we have had here this morning. So we are talking about many, many thousands of people who are involved here by your statement this morning.

Robert J. Hughes, chairman of the trusts and estates law section, New York Bar Association. This is the second Mr. Hughes we have had here this morning. Any relation?

STATEMENT OF ROBERT J. HUGHES, JR., ESQ., CHAIRMAN, TRUSTS AND ESTATES LAW SECTION, NEW YORK STATE BAR ASSOCIATION, NEW YORK, N.Y.

Mr. HUGHES. No, I am afraid not.

Thank you for permitting us an opportunity to appear before your committee. My name is Robert J. Hughes, Jr., chairman of the trusts and estates law section of the New York State Bar Association.

Mr. Chairman, we have approximately 3,600 attorneys specializing in the practice of trusts and estates in New York, and I can attest to the fact that as soon as the notice of these hearings went across out through the advance sheets, that I received several phone calls asking that I appear before your committee to testify for immediate repeal of the chapter 13 tax.

There is no doubt that of all the States, certainly the practitioners of New York have spent considerable time and effort, as has been testified here today from people from throughout this country, trying to come to grips with what we thought was a mistake in 1976 and has turned into, if it were not funny, a comedy of errors on behalf of the U.S. Treasury Department.

We are somewhat chagrined that they are able to come before this committee and make a proposal for a fix-up of the chapter 13, which in essence amounts to a repeal of it because there is very little in the new Treasury proposal which looks anything like the old chapter 13, except, unfortunately, certain aspects of the current chapter 13 law, which are unworkable and unadministerable.

We support the repeal immediately of the chapter 13 tax. Let me briefly, however, as has been mentioned before, outline some of the problems we see with respect to the Treasury proposal.

We think this is the first time or an attempt to tax the direct transfer of property which is not in trust to a future generation. Although we understand, we suspect, however, that the Treasury's attempt here is to prevent the concept of layering, which has been one of the aspects that practitioners have used to avoid what we thought were some of the problems in the chapter 13 tax. We feel, however, that the wisdom of taxing direct transfers is something that Congress has yet to speak on. We do not take a position with respect to that, but feel that unless this type of taxing transfer is brought within the common concepts currently in the estate and gift tax area, that we will just be heading down a road which will present serious problems for us in the future.

I would, however, in addition to speaking to the issue of repeal of generation-skipping, wish to lend the support of the New York State Bar Association to S. 1210, which would allow the election of an alternate valuation date on a late-filed estate tax return. As far as I know, the Federal estate tax return is the only one in which such severe penalties are imposed for late filing, penalties which go far beyond whatever additional moneys may be due and owing.

We are not saying that tax returns should not be timely filed, but what we are saying is once the interest and penalties are paid for those late-filed returns, the other benefits that the decedent's estate would otherwise have, such as alternate valuation, should be made available. And we feel as though S. 1210 goes in that direction.

We would also like to bring to your attention what we think is a problem which arose under and as a result of the Economic Recovery Tax Act of 1981 for certain State jurisdictions in which there is imposed a substantial State tax. That is the tax-on-tax problem. I understand that there will be testimony later this afternoon addressing that issue. We have come to appreciate it in New York, where the payment of a State tax may in fact result in additional Federal tax.

The last word, Mr. Chairman, is that we have followed the Federal footsteps in New York in enacting the new unlimited marital deduction. Our new law goes into effect beginning October 1 of this year, and I can tell you that it is taking a good 2 years of effort on behalf of all of the members of the Bar and the Bankers Association and other interested parties to bring that breath of fresh air up from Washington to New York. We are very thankful to you and others who have led the way toward reform in the estate and gift tax law area.

One additional comment, and that has to do with S. 1180. We support that piece of legislation. In this respect I think New York is a little bit ahead of the Federal law in allowing a disclaimer where you have a future interest involved. We have had the disclaimer law and renunciations for some time in New York, and it felt as though that has been a benefit to the consumer, and feel as though the disclaimer provisions on the Federal level ought to be expanded, as S. 1180 does.

With that final comment, thank you very much for this opportunity to appear.

[The statement of Mr. Hughes follows:]

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NYSBA

June 23, 1983

Senate Committee on Finance
Subcommittee on Estate and Gift Taxation

Re: Hearing dated June 27, 1983

On or about April 29, 1983, the United States Treasury Department made two proposals relating to generation-skipping transfer taxation. The first recommendation is the repeal of the current tax on generation-skipping transfers, retroactive to the original effective date of that tax. The second proposal is the enactment of a new type of tax on generation-skipping transfers. At this time, we understand that the Treasury Department has not made public the draft legislation which would enact the new tax on certain generation-skipping transfers.

We are in complete agreement with the first proposal which calls for the repeal of the current generation-skipping transfer tax system. We agree with the Treasury Department that there are such problems with the present generation-skipping transfer tax system that it must be repealed retroactively. We agree that the present system is too broad in scope, is extremely

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difficult to understand, is unduly complex from an administrative standpoint and is unfair. Indeed, the generation-skipping transfer tax system currently in the Internal Revenue Code conceivably could apply to almost any trust or trust equivalent created after 1976 (including transfers under the Uniform Gift to Minors Act, trusts for minors of a type described in Section 2503(c) of the Code and even outright transfers occurring during the administration of a decedent's estate). As the Treasury Department's own proposal demonstrates, the cost of dealing with this system (which we regard as inordinately high) either has to be borne by clients or absorbed by practitioners, and in any event, the generation-skipping tax system must be considered in almost every estate plan and the administration of almost every estate and trust. In order to avoid having this cost continue to be borne by the public and by practitioners, we urge the immediate repeal of the present generation-skipping transfer tax system. It seems crystal clear to us that the repeal of the present system does not have to wait until the ultimate design of any substitute system is determined.

With respect to the second proposal of the Treasury Department concerning a new generation-skipping transfer tax, we have the following comments.

For the first time, the Treasury proposal would attempt to tax the direct transfer of property (not in trust) to future generations. We understand that the proposal is an attempt to prevent the concept of "layering" which has been touted as a planning technique to avoid the present provisions of the generation-skipping transfer tax embodied in Chapter 13 of the Internal Revenue Code. Aside from the proposal's attempt to close this supposed loophole in Chapter 13, we question the wisdom of taxing an outright transfer at all to a future generation. We do not believe that the enactment of the present Chapter 13 tax was meant to bring into taxable transfers any outright transfers. We know of no system of taxation which would tax outright transfers either by gift or by will to future generations apart from the estate or gift tax already assessed against such transfers.

In addition, we question the wisdom of trying to incorporate income distributions under the Treasury proposal and suggest that the appropriate remedy in this area is a revision of Subchapter J of the Internal Revenue Code, as opposed to incorporating the taxation of income distributions under a wholly new tax system.

We look forward to receiving and reviewing the draft legislation incorporating the Treasury proposal to simplify generation-skipping tax, but feel that in the interim, a repeal of the generation-skipping transfer tax system currently in the Internal Revenue Code is appropriate and urge you to do so.

Respectfully submitted,

New York State Bar Association
Trusts and Estates Law Section

By
Robert J. Hughes, Jr., Chairman

Senator SYMMS. I wish to thank all of you very much for very excellent contributions to our hearing record. I know that it will be helpful. We also appreciate your offers for continued support and interest to this committee and what we are trying to do because without support of people like yourselves, we would not be able to continue to push this case forward. So thank you very much.

The final panel for this morning is Mr. Seidman, Mr. Iskrant, Mr. Warden, Mr. Bellatti, Mr. Smith, and Mr. Abbott. So gentlemen, please come forward.

I might just say while you are being seated, my thanks to all of the witnesses who have testified with us here this morning and this afternoon, and I think also I would like to pay my thanks to Miss Ann Canfield from my staff who has been one of the prime movers of this legislation and has pushed forward with it consistently in her work on the Senate Finance Committee, and I certainly appreciate that.

Mr. Seidman.

STATEMENT OF P. K. SEIDMAN, MEMPHIS, TENN., ACCOMPANIED BY SHELDON S. COHEN, ESQ., COHEN & URETZ, WASHINGTON, D.C.

Mr. SEIDMAN. Good afternoon, Senator. Mr. Chairman, my name is P. K. Seidman. I am an attorney and certified public accountant and I am from Memphis, Tenn. I am here with counsel, the Honorable Sheldon S. Cohen, who is sitting right behind me.

At the outset, let me convey my thanks and express appreciation for allowing us this opportunity to present some information to the committee, through you, dealing with S. 1210.

Now I have a formal statement prepared and which I believe has been presented to the committee. I respectfully request that it be made part of the record.

Senator SYMMS. So ordered.

Mr. SEIDMAN. Thank you.

Let me cover a few items in summary of the principal points of that statement. Now section 2032 of the code was spawned by the depression of the 1930's, but it took the 1970's type of recession or depression to highlight a very serious, harsh, and undue hardship lodged in that code section. That is why the majority leader of the Senate, Senator Baker, and Senator Sasser, also from Tennessee and from across the aisle, introduced S. 1210. S. 1210 serves to amend section 2032 of the code.

This proposal is also sponsored by Senator Riegle of Michigan and Senator Lugar of Indiana. And I might add, there are several other Senators and Congressmen who have expressed a favorable attitude toward S. 1210.

Of special interest to the committee may be that S. 1210 will probably increase revenue and not decrease it or reduce it. And in these days of deficits, this is a refreshing note.

Now I mentioned the harsh and undue hardship of the present code. Here is what I mean. As the code stands today, filing the estate tax return late, even 1 day, can bring a substantial estate tax deficiency and clean out a fairly large estate with almost nothing left for the rightful heirs.

Now S. 1210 does not, on the other hand, create a taxpayer windfall. It only assures the estate of that which the tax laws intended it to have all along. S. 1210 merely allows every estate the exact same treatment by allowing the alternate value election in the first filing of the return, even if that return is filed late.

This is something that even the Treasury Department accepts as fair. Our point of departure with the Treasury, however, is the transition retroactive application of S. 1210 where the estate tax file has not been closed with the IRS. In other words, the statute of limitations has not run.

Now, in my opinion, it certainly should apply retroactively. My formal statement, which you have, sets forth that Congress has adopted this method of changing unintended bad law to the original intended good law. And the Treasury is far from a stranger to this approach. It went along with it many times, as in 1981, the Economic Recovery Tax Act, special valuation methods for farm property under section 2032, which eliminated the timely filed return requirement.

Again in 1981, in section 2056, property passing to the spouse without tax, regardless of the timeliness of the return. Another one in 1981, section 168, straight line depreciation election rather than deduction under the accelerated cost recovery system, even if the return is filed late. And also the election under section 121 for those over 55 years of age to elect to exclude gain on sale of residence if the return is filed within 3 years of the due date.

Now, understandingly, the Treasury generally speaks out against retroactive tax measures. Yet it frequently also champions such legislation. Thus, on March 17, 1978, the Treasury supported the miscellaneous technical changes of Public Law 95-268 before the Subcommittee on Taxation and Debt Management and its retroactive provisions apply to a subchapter S election. Subchapter S was earlier also covered by retroactive amendments in Public Law 89-389, as it was also in Public Law 91-686, and in the DISC legislation, which was covered in Public Law 91-686, with retroactive features endorsed by the Treasury.

There can be no greater undue hardship than in the case of my client, an executor, a month before the due date of the estate tax return, found themselves hospitalized for heart bypass surgery, which resulted in a late return which summarily took away from the estate the election of the section 2032 alternate value.

Let me point out, too, that the code calls for adequate and necessary penalties for late filing. Moreover, the Treasury can and does excuse these late filings for reasonable cause. And so it is indeed incongruous to impose an inflexible, much harsher penalty when late filing has more reason than the discretion given the Commissioner in cases of reasonable cause late filing.

Now I have attempted to briefly give you an outline. With your permission I would like to ask counsel, Sheldon Cohen, to take up the technical provisions of S. 1210. If, on the other hand, at this point you want to field some questions for me, I will be glad to attempt to answer.

[The statement of Mr. Seidman follows:]

STATEMENT OF P.K. SEIDMAN
CONCERNING S.1210
BEFORE THE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION, SENATE FINANCE COMMITTEE

My name is P.K. Seidman. I am an accountant and an attorney from Memphis, Tennessee. My testimony today is in support of S.1210, a bill introduced by Senators Howard H. Baker and James Sasser, and co-sponsored by Senator Donald W. Riegle. S.1210 would amend sections 2032(a) and 2032(c) of the Internal Revenue Code relating to the valuation of property for estate tax purposes on an alternate date after a decedent's death. The adoption of S.1210 will significantly improve the operation of the alternate valuation date legislation, and will bring these provisions into conformance with the intention of Congress.

Introduction

Section 2032 provides that an executor of an estate may make an election on a timely filed estate tax return to value the property of the decedent at its value six months after the date of death. This alternate valuation date may be utilized instead of valuing the estate's property on the actual date of death. The purpose behind the institution of this elective alternate valuation date is the prevention of harsh and unjust results caused by the imposition of estate tax at the fixed date of death valuation of property where such property declines in value shortly after death. The provision was a response to the economic decline of the 1930's, which resulted in the imposition of estate tax on values non-existent at a time shortly after the date of death. The estate tax in such a case can consume the entire estate leaving nothing for the beneficiaires. The Congressional response was meant as a remedy to an excessive tax imposed upon estates and to avoid bankrupting estates which have declined in value.

Under existing law, election of the alternate valuation date is unavailable if the estate tax return is filed late. Since the purpose of the alternate valuation date is not related to the purpose behind the requirement of timely filing, it is incongruous to deny the availability of the alternate valuation date as a punishment for a late filing. The alternate valuation date election was intended not as a reward for timely filing but as a remedy for an otherwise harsh result. The requirement of current law, by denying the alternate valuation date election because the estate tax return is filed late, frequently results in the imposition of the same harsh penalty which Congress sought to avoid.

Section 2032 was not needed nor was it intended to encourage prompt filing of estate tax returns, since a substantial penalty for late filing is specifically provided for in section 6651 of the Internal Revenue Code. Indeed, the late filing penalty is not automatic. The late filing penalty may be excused if there is reasonable cause for the late filing. Denial of the alternate valuation date, however, is automatic. The operation of current law is in conflict, then, since the alternate valuation date election is automatically denied even when no late penalty is imposed on a delinquent return. This circumstance occurred for the Estate of Sylvia Buring, with which I am personally familiar. Moreover, section 2032 can bankrupt an estate, a result that is far harsher than the penalty considered appropriate for late filing under section 6651. Enactment of S.1210 would correct this rule by allowing the alternate date valuation election to be made even on a late return, subject to certain restrictions. As under present law, the election, if made, would be irrevocable.

The timely-filed return requirement for the alternate valuation date election is also inconsistent with the treatment of elective tax benefits under other Code sections. Section 2032A, relating to the alternate valuation of certain farm and real property, has a similar elective provision to that of section 2032(c). Section 2032A allows an election to be made to use a special valuation method for certain farm property. Prior to 1981, the election of special-use valuation under section 2032A was available only if made on a timely filed return. The Economic Recovery Tax Act of 1981 amended section 2032A, however, so that the election can be made even if the estate tax return is filed late. According to the Report of the House Committee on Ways and Means, the amendment was enacted because "qualified heirs should not be deprived of the benefits of current use valuation solely because the decedent's estate tax return is filed after the date on which it is due." The same rationale applies to section 2032(c), and S.1210 would accomplish this result.

Other election provisions of the tax law also permit an election with a late-filed return. For example, section 2056(b)(7), enacted in 1981, allows an executor to make an election to permit certain property to pass to the decedent's spouse without the imposition of estate tax. The election may be made without regard to the timeliness of the return. Under section 168(f)(4)(A), also enacted in 1981, an election to claim straight line depreciation deductions in lieu of the deductions provided for by the Accelerated Cost Recovery System may be made even if the return is filed late. Similarly, section 121(c) allows individuals over 55 years of age to elect to exclude the gain on a sale of their principal residence provided the return is filed within three years of the due date.

There simply is no valid reason to deprive qualified heirs of the benefit intended by section 2032 simply because the tax return is filed late.

Restrictions on Late Elections

Legislation similar to S.1210 was introduced in the 97th Congress. The Treasury Department agreed with the substantive changes in the estate tax alternate valuation date election, but expressed the concern that executors could abuse the election on a late return. The potential for abuse stems from the ability of executors to delay filing solely for the purpose of using the election to gain maximum income tax advantage. For example, one consequence of allowing the election on a late return is a delay in the determination of the proper basis of assets. As a result, a beneficiary could perhaps use a high basis arrived at by use of the date of death valuation and later the executor could elect the alternate valuation and the basis for income tax purposes would be subject to a retroactive decrease.

In order to preclude this abuse, the Treasury Department suggested a "reasonable cause" rule under which election of the alternate valuation date would not be permitted unless there were reasonable cause for the late filing. S.1210 does not ultilize a reasonable cause test. Rather, S.1210 responds to this problem in two ways. First, the election of the alternate valuation date on a late return is not permitted if one of the principal purposes of the late filing is to take advantage of hindsight in determining if the election should be made. This approach directly responds to the Treasury Department's concerns and appears to be more effective than the "reasonable cause" rule. Second, S.1210 places a limit on how late a return may be filed and still be permitted to elect the alternate valuation date. S.1210 provides that the election is available only on returns filed within one year of the prescribed filing time. This provision, suggested by the Treasury Department, avoids administrative difficulties in determining the proper income tax basis for beneficiaries of the estate.

While the "principal purpose" test and the "one-year rule" are two responses to the problem identified by the Treasury, they are not the only satisfactory responses. I would be pleased to work with the Subcommittee and its staff in arriving at a satisfactory response to this problem.

Denial of Election Where Estate Has Not Declined In Value

Treasury Department testimony on prior legislation under section 2032 highlighted a potential for unintended use of the alternate valuation date election on timely as well as late returns. This problem arises from the ability of executors to elect the alternate valuation date solely to gain an increased basis for income tax purposes, with little or no estate tax effect. This could occur, for example, if the value of assets on the alternate date was higher than the value on the date of death. In such a case, if the alternate date is elected, the beneficiary receives an income tax basis equal to the valuation for estate tax purposes. Thus, the income tax basis is higher than if such basis had been determined using the value of the assets on the date of death. If the alternate valuation date election is allowed in an estate which transfers all of its assets to the spouse, the election does not serve any estate tax purpose, since no estate tax is due. An election in such a case, however, could be made under current law and could result in an increase in the income tax basis of the assets. As the Treasury testimony during the 97th Congress points out, it was not the intent of Congress to permit the alternate valuation date election to be used mainly for income tax considerations. The elective provision was enacted in response to economic decline, and the Congressional intent was clearly to aid estates declining in value and otherwise unfairly burdened.

The current bill provides a response to the problem identified by the Treasury. S.1210 denies the alternate valuation date election to all estates where the value of the assets on the date of death is lower than on the alternate valuation date, excluding property qualifying for the marital or charitable deduction in making the determination. The election is allowed only if the executor in good faith establishes a decline in value, and files a statement to that effect. If the alternate valuation date is allowed, the tax basis of all the property is based on the alternate date valuation. With this provision, S.1210 makes another important step in conforming the alternate date valuation elective rule to the intent of Congress.

S.1210 also provides expressly that election of the alternate valuation date is not permitted if the tax shown on the estate tax return is less than the applicable estate tax credit. This rule is consistent with the Internal Revenue

Service position under current law. Current law, however, is not explicit regarding this limitation.

In making this change, S.1210 avoids a significant potential revenue loss to the Treasury. The possibility of unintended income tax benefits for property for which the marital deduction is allowed, for example, would be reflected not only in reduced income tax on ultimate disposition of those assets, but also in higher depreciation deductions which would reduce income tax currently. While it may be difficult to predict the total revenue savings from this change, there is no doubt that it will avoid unintended income tax results.

As in the case of the principal purpose test discussed above, there are a number of possible approaches to the unintended income tax effect of the alternate valuation date election. I would be pleased to work with the Subcommittee and its staff, if it chooses to develop an alternative method of limiting the income tax basis where property included in an estate has gone up in value.

Transitional Rule

The denial of the alternate valuation date where the estate has not declined in value will apply to the estates of decedents dying after the date of enactment. The change permitting an election on a late-filed estate tax return also applies, generally, to decedents dying after the date of enactment. A transitional rule is also provided that would remove the inequitable effect of present law by permitting the new rule to apply where the decedent died before the date of enactment, and the estate tax return is filed after the date of enactment. Also, the transitional rule applies in cases where the estate tax return has been filed late, but the statute of limitations on the determination of the tax liability of the estate remains open. Given the sound legislative policy of S.1210, there is no satisfactory reason for not making the law retroactive to eliminate the inappropriate consequences of the old rule for estates for which the statute of limitations remains open. Similar provisions have been frequently applied retroactively by Congress in this way so as to provide the benefit of an ameliorative change in the law in those cases where it is administratively feasible, while avoiding the administrative difficulties involved in reopening estates closed under the statute of limitations. Retroactive application of a change in law, subject to the statute of limitations, has not resulted in administrative difficulty in other tax provisions such as, for example, changes in the Subchapter S election provisions. There is, therefore, no reason to make the change in law prospective only, and thereby insure that the maximum number of parties suffer because of an inappropriate and unjustifiable tax policy.

Estates to which the transitional rule in S.1210 applies do not receive a windfall. No election not otherwise provided by law is made available nor may any estate change an election. The election once made becomes irrevocable. The alternate valuation date remains the date exactly six months after the date of death, regardless of the date the original estate tax return was filed. The effective date provision does not bestow an advantage over any other estate. It merely allows for equal treatment of all estates in similar circumstances. Estates that had been unduly penalized, contrary to the intent of Congress, are put back on par, subject to the statute of limitations.

Adoption of the transitional rule provided in S.1210 corrects an inequitable and improper rule, providing relief to those estates still open under the statute of limitations, where a harsh penalty would otherwise be extracted.

I hope that this Subcommittee will act promptly and favorably report S.1210 to the full Finance Committee for its consideration.

Senator SYMMS. Thank you very much, Mr. Seidman. Did you want to make a very brief comment?

Mr. COHEN. I think, Senator, in the interest of time we will submit the statement for the record. I would just like to point out that the Treasury today has indicated its support for the rule that we have enunciated. We have attempted to write this rule as carefully as we can so that it does not go broader than correcting the acknowledged problem and does not open up any holes that the Treasury would not want. We would be glad to discuss any technical amendments with them and your staff. It is a good rule. The New York Bar Association tax section just endorsed it a few moments ago and it would provide an equitable solution to a difficult problem.

Treasury's purist view of retroactivity is kind of silly in light of Mr. Seidman's statements. Any number of times Treasury has found the appropriate remedy. The only time you can remedy a hardship is to remedy it when you find it. The only way we find a problem is for somebody to come up with a case that shows an anomaly in the statute. Then we correct it.

Now the Treasury is willing to correct it, but not for the very person whose situation gave rise to the problem.

Senator SYMMS. Thank you very much. We will look forward to your written recommendations, which we have made a part of our record.

I might just state for the record that our hearing record will be kept open for 30 days for any witnesses who wish to include statements in the record.

Now we will hear from Mr. Iskrant.

STATEMENT OF JOHN D. ISKRANT, ESQ., SCHNADER, HARRISON SEGAL & LEWIS, PHILADELPHIA, PA.

Mr. ISKRANT. I am an estates practitioner in Philadelphia and am here today to discuss with the committee and present testimony on what I believe is an unintentional technical problem with the Economic Recovery Tax Act.

Previous comments have been to the effect that the Economic Recovery Tax Act is certainly a milestone as far as estate and gift taxation are concerned, but there are certain technical problems, the alleviation of which would be appropriate in furthering the goals of the legislation as enacted.

The particular problem I have in mind relates to the unlimited marital deduction for Federal estate tax purposes. The apparent intent behind the provision of an unlimited marital deduction is to impose no Federal estate tax in a situation in which a spouse leaves all of his or her property to a surviving spouse. Nevertheless, State inheritance tax and State death tax systems can distort the Federal estate tax results in that situation. I would like to illustrate that by an example, using the Pennsylvania inheritance tax as a base.

In Pennsylvania, instead of there being an unlimited marital deduction, quite to the contrary, there is a flat 6-percent tax on property passing from husband to wife or wife to husband. The only exclusion from that is jointly held property. But in general, any property passing under a will or under in testacy from a husband to a wife or wife to a husband is subject to a 6-percent tax.

Take a simple dramatic example that doesn't come up very often, but the numbers are easy to deal with. If a husband died who had an estate composed of a business interest or a farm or any other type of assets and the aggregate estate was $100 million, the husband had a simple will that says I leave everything to my wife, one would think that there is no Federal estate tax because of the unlimited marital deduction.

Quite to the contrary, however, in Pennsylvania and in many other States—I think there are 23 other States affected—the $100 million estate would be subjected to the 6-percent State inheritance tax, which would leave a net of $94 million going to the surviving spouse. The Federal Government would then impose the Federal estate tax on the $6 million which went to the Commonwealth of Pennsylvania, and the initial computation would show that there would be a $2.5 million Federal estate tax on the $6 million which went to the Commonwealth of Pennsylvania.

So even though in this example the man had tried to leave his business to his surviving spouse in a simple one-sentence will, there would be a Federal——

Senator SYMMS. Who has to pay that? The State of Pennsylvania?

Mr. ISKRANT. No, the tax would have to be paid by the recipient of the property; namely, the spouse.

Senator SYMMS. Well now wait a minute. You said the estate was $100 million. The guy dies, leaves it to his wife so there is no Federal estate tax.

Mr. ISKRANT. Initially, it would appear.

Senator SYMMS. But there is a 6-percent Pennsylvania tax so then the estate pays $6 million to Pennsylvania.

Mr. ISKRANT. Right, and the estate is the recipient, the surviving spouse, because it is she who has all the property in the estate. But she would write a check or the executor of the will would write a check to the Commonwealth of Pennsylvania for $6 million. Then the executor would go to prepare a Federal estate tax return. It would show gross assets, $100 million; marital deduction, $94 million because it was only $94 million which went to the surviving spouse. The other $6 million went to the State of Pennsylvania.

So on the Federal estate tax return there would remain $6 million, ignoring for the moment the unified credit amount, which would be subject to tax. So under the current estate and gift tax law, the Federal Government would impose a tax on an amount going to the State of Pennsylvania.

It is actually worse than that because the Federal Government would then impose a tax on its own tax, so that in this example there would be more than $2.5 million of Federal estate taxes paid, even though the individual in question had tried to leave all his property to his surviving spouse.

I have picked intentionally the example of a very large business or farm or gross asset situation for simplicity of calculations, but it would also apply to much smaller cases, particularly if some of the unified credit amount were used for gifts to children or to other persons.

I would like to say in closing that I have informally polled other estate practitioners in Pennsylvania who are unanimously of the view that this situation is anomalous in the extreme, where the Federal Government imposes a tax on amounts going to a State. And it seems particularly inappropriate in a time where the States are being encouraged to raise revenue on their own, to have the Federal Government tax amounts going to the States.

Senator SYMMS. Thank you very much. I wasn't personally aware that that was happening, and I think that that is something that needs to be looked at. Maybe some of the States—I suppose you have probably tried it at the State level and maybe to no avail up until this point, to make some accommodation. Some States I think are following suit to the Federal Government on interspousal transfer.

Mr. ISKRANT. That is correct, Mr. Chairman, but there is no legislation in Pennsylvania that has any chance of passage which would repeal the flat 6-percent tax, and I understand that that is the situation in many other States as well.

Senator SYMMS. I suppose if there were some way that the State of Pennsylvania would have to pay the tax on it then they would come to the table pretty fast. But as long as there is an asset left in the estate, then the estate is liable for the tax. Is that correct?

Mr. ISKRANT. Yes, Mr. Chairman.

Senator SYMMS. I see.

Mr. Warden.

STATEMENT OF ROBERT A. WARDEN, ESQ., McDERMOTT, WILL & EMERY, WASHINGTON, D.C., ON BEHALF OF THE SPRINGFIELD MARINE BANK, SPRINGFIELD, ILL.

Mr. **Warden**. Thank you, Mr. Chairman. My name is Robert Warden. I am a partner in the Washington office of McDermott, Will & Emery. I appreciate the chance to appear today on behalf of the Springfield Marine Bank in support of S. 1180.

The Springfield Marine Bank is the executor of the estate of George W. Bunn, Jr. Mr. Bunn's aunt, Alice E. Bunn, devised a portion of her estate to the Springfield Marine Bank of Springfield, Ill. to be held in trust. The trustee was directed to pay one-half of the income of the trust to her nephew, George W. Bunn, Jr., then 63, for a period of 20 years. The will further provided that if her nephew survived this 20-year period, that an interest in one-half of the trust corpus would fully vest in him. If he did not survive, this interest would then pass to his three children.

In 1953, at the time the interest here was created, case law was clear that a disclaimer which was valid under State law was also valid for Federal tax purposes. In 1958, 5 years after the death of Alice Bunn, the Internal Revenue Service issued Regulation Section 25.2511-1(c) which provided in relevant part that a disclaimer or refusal must be "made within a reasonable time after knowledge of the existence of the transfer". Otherwise, the disclaimer would be treated as a gift from the party making the disclaimer to the other beneficiaries under the will or trust instrument.

The ultimate effect of this change in the regulations has been that the IRS, now 25 years after the fact, asserts that after 1958, for Federal gift tax purposes, a disclaimed interest is created at the time when the original instrument establishing the interest became effective, and not when the interest became vested. But this was by no means clear at the time.

This morning Treasury, in opposing this legislation, made a statement to the effect that in sponsoring it, the effort was to create a benefit on taxpayers who had willingly and knowingly taken positions contrary to that of the Internal Revenue Service.

This statement, in my opinion, is shockingly disingenuous. In actual fact, in 1966 in a private letter ruling, the IRS took the position that disclaimer of an interest created 33 years earlier but which had only recently become possessory, was valid. I might add, the IRS forgot to mention this when it litigated the *Jewett* case. The IRS did not publicly assert its current interpretation of the law until the litigation in the *Keinath* case in 1973, which incidentally, they lost. The eighth circuit reversed the Tax Court and held that the reasonable time requirement for a valid disclaimer pertains not to the time after the creation of the interest but to the time immediately after the interest vests or becomes possessory.

The eighth circuit opinion in the *Keinath* case was announced on May 8, 1973. Mr. Bunn made his disclaimer on August 10, 1973, one day after it vested.

The issue was relitigated, as we know, in 1982 and the Supreme Court handed down its decision in the *Jewett* case. In a 6 to 3 decision the Court held that the word "transfer" as found in the regulation refers to the time when the interest was created, and not to the later time when it vests or becomes possessory.

Whatever the merits of this rule, as applied to future cases, we feel that the regulatory and judicial history of this matter operates to work a serious injustice on the estate of Mr. Bunn and others similarly situated.

At the time when the original trust was created in 1953, the Treasury regulations, which the IRS now relies on, were not even in effect. Mr. Bunn did execute a disclaimer of his interest in the corpus valid under Illinois law one day after that interest vested, and also within a few months of the court decision in the *Keinath* case, which held that such a disclaimer was valid for Federal gift tax purposes. Mr Bunn had not accepted his interest in the corpus or any of its benefits at the time of the disclaimer.

Apparently, Treasury now says that the disclaimer here should have been made in 1953, 5 years before the regulations were promulgated and 20 years before the IRS first litigated this issue successfully.

S. 1180, as introduced by the chairman, Senator Boren, and Senator Wallop, would correct this situation by providing a transition rule for a disclaimer of an interest created by a transfer made before November 15, 1958. Under the bill, the disclaimer of such an interest would be valid for Federal tax purposes if made at any time prior to 90 days following the date of enactment of this legislation.

We thank the chairman and the other Senators for introducing this and we believe that such a solution is fair and urge enactment.

[The statement of Mr. Warden follows:]

BEFORE

THE SENATE COMMITTEE ON FINANCE

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

JUNE 27, 1983

Testimony

of
Robert A. Warden
McDermott, Will & Emery
on behalf of
The Springfield Marine Bank

SUMMARY OF PRINCIPAL POINTS

1. Prior to November 15, 1958, when Treasury amended its regulations with regard to disclaimers of interests in property, there was no indication that disclaimers made immediately after an interest had vested might be taxable as gifts.

2. Persons holding interests in property created prior to November 15, 1958, were unfairly treated because of this retroactive change in law.

3. S. 1180 should be enacted to prevent unfairness to taxpayers disclaiming interests created before the change in Treasury regulations.

S. 1180

My name is Robert A. Warden. I am a partner in the Washington office of McDermott, Will & Emery. I am appearing today on behalf of the Springfield Marine Bank in support of S. 1180.

The Springfield Marine Bank is the executor of the estate of George W. Bunn Jr. Mr. Bunn's aunt, Alice E. Bunn, devised a portion of her estate to the Springfield Marine Bank of Springfield, Illinois, to be held in Trust. The trustee was directed to pay one half of the income of the trust to her nephew, George W. Bunn, Jr. for a period of 20 years. The will further provided that if her nephew survived this 20 year period, then an interest in one-half of the trust corpus would fully vest in him. If he did not survive, this interest would then pass to his three children.

In 1958, five years after the death of Alice Bunn, the Internal Revenue Service issued Regulation Section 25. 2511-1(c) which provided in revelant part that a disclaimer or refusal must be "made within a reasonable time after knowledge of the existance of the transfer;" otherwise the disclaimer would be treated as a gift from the party making the disclaimer to the other beneficiaries under the will or trust instrument.

The net effect of this change in the regulations is that the IRS now asserts that after 1958, for federal gift tax purposes, a disclaimed interest is created at the time when the original instrument establishing the interest became effective and not when the interest became vested.

In fact, however, in a 1966 private letter ruling the IRS allowed the disclaimer of an interest created 33 years earlier, but which had only recently became possessory. The IRS did not publicly assert its current interpretation of the law until the litigation in Keinath v Commissioner, 58 T.C. 352, rev'd. 480 F.2d 57 (8th Cir. 1973). The Eighth Circuit reversed the Tax Court and held that the reasonable time requirement for a valid disclaimer pertains not to the time immediately after the creation of an interest, but to the time immediately after the interest became vested or possessory. The Eighth Circuit's opinion in Keinath was announced on May 8, 1973. Mr. Bunn made his disclaimer on August 10, 1973.

However, this issue was relitigated and on February 23, 1982, the Supreme Court handed down its decision in Jewett v. Commissioner, 455 U.S. 305. In a six to three decision the Court held that the word "transfer," as found in the regulation, refers to the time when the interest was created and not to a later time when the interest vests or becomes possessory.

Whatever the merits of the rule in Jewett as applied to future cases, we feel that the regulatory and judicial history of this matter operates to work a serious injustice on the estate of Mr. Bunn. At the time when the original trust was created in 1953, the Treasury regulations which the IRS now relies on were not even in effect. Mr. Bunn did execute a disclaimer of his interest in the corpus, valid under Illinois state law, one day after that interest vested and also within a few months of the court decision in the Keinath case which held that such a disclaimer was valid for federal tax purposes. Mr. Bunn had not accepted his interest in the corpus or any of its benefits at the time of his disclaimer.

S. 1180, as introduced by Senator Symms, Senator Boren and Senator Wallop, would correct this situation by providing a transition rule for a disclaimer of an interest created by a transfer made before November 15, 1958. Under the bill, the disclaimer of such an interest would be valid for federal tax purposes if made at any time prior to 90 days following the date of enactment of this legislation. We believe that such a solution is fair and urge the enactment of this legislation.

Senator SYMMS. Thank you very much for your testimony, Mr. Warden. We appreciate it.

Mr. Bellatti.

STATEMENT OF ROBERT M. BELLATTI, ESQ., McDERMOTT, WILL & EMERY, SPRINGFIELD, ILL., ON BEHALF OF THE ILLINOIS STATE BAR ASSOCIATION, CHICAGO, ILL.

Mr. BELLATTI. Thank you very much, Senator Symms, for giving us the opportunity to testify. For the record, my name is Robert Bellatti. I am here representing the Illinois State Bar Association. I might also mention, while I am not in a representative capacity, I am a member of the American Bar Association committees that deal with the estate tax problems facing farmers.

My testimony today is devoted to a few suggestions for technical improvements in the current use or special use valuation rules for estate tax. The press release for this hearing announced that you were seeking such recommendations. At least in terms of oral testimony, I believe I am the first speaker in this long day of testimony to speak to these issues.

Fortunately, due to the efforts of Senators Symms, Wallop, Boren, Bentsen, Grassley and several others back in 1981, I don't have nearly as much to say today as I would otherwise have because of ERTA, [Economic Recovery Tax Act] in 1981, that did a great deal to correct major structural problems in section 2032A.

Unfortunately, there still are a few matters that need correction, and in the interest of time and also because I am sure many of you who are not familiar with these matters would not want to hear a technical discussion of these improvements, I would simply make note of the fact that in my written testimony I have actually included suggested statutory language to implement most of the recommendations.

I think I should, however, mention a couple of cases which I believe you would find interesting and which show why we are making these suggestions. One area has to do with the partial recapture tax, where a farm has been valued after the decedent has died under the special use provisions and then for family reasons there is a sale of part of the real estate after the death by the qualified heir.

For example, in one particular case the son, who is a farmer, inherited the farm from his father, who was a farmer, and found it necessary, due to the extremely poor farm economy and some operating debt that he had, to sell one-half of the farm 3 years after his father died. One would think that this would lead to a recapture of one-half of the tax that was saved under the special use valuation rules. Unfortunately, however, this led, according to the IRS interpretation, to a recapture of all of the tax that was saved by special use valuation that was saved on the entire farm, not just on the part that was sold but on the entire farm. This is in spite of the fact that one-half of the farm could have been valued under the special use valuation rules in the first place.

This is obviously not an equitable result. I don't believe it is really required by the present law, but given the Treasury position, it seems that corrective legislation of a very simple type should be enacted, and this is included in my testimony.

The other area that I would like to point out is the successive interest rule. This is a rule that says that in order for the farm to qualify for special use valuation, all of the interests in the farm must pass to qualified heirs. Nowhere in the Internal Revenue Code will you find this requirement but the present Treasury regulation states that this is the case, and that may seem to be a very logical rule. If it is a family farm, the farm should pass to family members to qualify for this benefit.

The problem comes when good estate planning is combined with a family farm situation. I will tell you of one case where the chances that the farm will go to a nonfamily member within the recapture tax period are one in 134 quadrillion. If you have any idea how small a number that is, that is roughly one soybean out of all the soybeans produced this year in the United States, approximately 2 billion bushels, 88,000 beans in a bushel. One chance out of that that it would go to a nonfamily member.

In this case the farm is left in trust for the children, and on the death of all the children, the farm goes to the grandchildren. If there are no grandchildren then living, then the farm goes to a local charity. This is a very typical provision.

I am arguing a case tomorrow for technical advice over at the IRS building where we have the same issue in a case where the mother died first, left her interest in the farm to dad for his life, who was an operating farmer, and then it goes to the three sons on dad's death. One of the sons is farming the land.

The Service has disallowed the special use valuation. This is a rather small and meager situation where the tax involved is just under $100,000. It is being disallowed for a couple of reasons. One of them is the same one, that if there are no descendents living when dad dies, then the farm is to go to a charity. The odds of that are extremely remote.

Second, the Service has taken the position that when the return was filed, the agreements of dad and the three sons were filed with the return, but because there were no agreements filed on the special valuation for some then-living grandchildren who do not take the farm unless one of their parents fails to survive the father, $100,000 of additional tax is due.

Now it is my understanding that Treasury is in the process of reevaluating this rule. Hopefully they will do so and it will provide much needed relief. But in the event that the rule is not revised, then I think we are going to be coming back very soon and asking for legislation on the successive interest rule.

Thank you for your attention.

[The statement of Mr. Bellatti follows:]

STATEMENT OF ILLINOIS STATE BAR ASSOCIATION FOR JUNE 27, 1983 HEARING OF SUBCOMMITTEE ON ESTATE AND GIFT TAXATION OF THE SENATE COMMITTEE ON FINANCE

The Illinois State Bar Association ("ISBA") is pleased to have the opportunity to submit this written testimony in connection with the June 27, 1983 hearing of the Subcommittee on Estate and Gift Taxation of the Senate Committee on Finance. As a past Chairman of the Federal Tax Section of the ISBA, I am pleased to suggest some further modifications of the rules governing special use valuation. W. Timothy Baetz will be testifying separately for the ISBA here today on the generation-skipping transfer tax situation.

Although the Economic Recovery Tax Act of 1981 made many much needed modifications in the special use valuation rules, several further modifications are now necessary to implement fully the intent of Congress when it originally enacted the special use valuation rules in 1976. Unless otherwise indicated, it is suggested that in each case the modification be retroactive to January 1, 1977, the original effective date of the special use valuation rules.

Technical Amendment to Payment-In-Kind Tax Treatment Act of 1983

The PIK Tax Treatment Act of 1983 provides that a qualified taxpayer who materially participates in the diversion and devotion to conservation uses required under the 1983 PIK program shall be treated as materially participating in the operation of the farm during 1983 for purposes of the special use valuation rules. Section 3(a)(2) of the Act should be amended to make it clear that material participation in the diversion and conservation use by a family member (as defined in Section 2032A of the Internal Revenue Code) of a qualified taxpayer will also be treated as material participation for purposes of the special use valuation rules. If this treatment of such material participation by a family member is not recognized for purposes of the special use valuation rules, then the Congressional intent to make participation in the PIK program possible without adverse estate tax consequences may be thwarted in some family farm situations.

Qualified Use by Family Member of Qualified Heir

The Internal Revenue Service has taken the position that the special use valuation rules do not permit a family member to satisfy the qualified use requirement after the decedent's death for the qualified heir. For example, assume that a deceased farmer leaves his farm equally to his son and his daughter. The son is also a farmer and is the farm operator. Under the present IRS interpretations, if the daughter cash rents her interest in the farm to her brother at any time after 2 years have passed after the decedent's death, then the daughter's interest in the farm is not considered to be held in a qualified use and all of the estate tax that was saved by the special use valuation of the daughter's interest in the farm will be recaptured. This result is totally inconsistent with the family farm concept that is the foundation for the special use valuation rules.

To permit the qualified use requirement to be satisfied by a family member of the qualified heir, Section 2032A(c)(6)(A) of the Internal Revenue Code should be amended to read as follows:

> "(A) such property is not used by the qualified heir or any member of his family for the qualified use set forth in subparagraph (A) or (B) of subsection (b)(2) under which the property qualified under subsection (b), or"

Partial Recapture Tax Should Be Proportionate

The current Internal Revenue Service interpretation of the special use valuation rules makes it necessary to clarify the manner in which the amount of recapture tax is calculated when only a portion of the property which has been specially valued ceases to be used in a qualified use or is disposed of to a non-family member. The current IRS interpretation of the partial recapture tax rules results is a totally disproportionate amount of recapture tax being imposed when a qualified heir disposes of only a portion of his interest in the specially valued property. For example, where a decedent left two 80 acre farms to his son and the son had to sell one of the farms to pay his farm operating debts three years after his father died, the IRS ruled that all of the estate tax saved by the special use valuation of both farms was recaptured. The IRS made this harsh technical interpretation in spite of the fact that the son could have originally elected special use valuation on only the farm that was not sold.

Although a fairer interpretation of the present rules would result in a proportionate partial recapture tax, Section

2032A(c)(2)(D) should be amended to read as follows:

> "(D) PARTIAL DISPOSITIONS. -- For purposes of this paragraph, where the qualified heir disposes of a portion of the interest acquired by (or passing to) such heir (or a predecessor qualified heir) or there is a cessation of use of such a portion --
>
> (i) the term 'such interest' in subparagraph (c)(2)(A)(i) means the portion of the interest disposed of or with respect to which there is a cessation of use,
>
> (ii) the value determined under subsection (a) taken into account under subparagraph (A)(ii) with respect to such portion shall be its pro rata share of such value of such interest, and
>
> (iii) the adjusted tax difference attributable to the interest taken into accoun with respect to the transaction involving the second or any succeeding portion shall be reduced by the amount of the tax imposed by this subsection with respect to all prior transactions involving portions of such interest."

This amendment would clearly limit the amount of the recapture tax to the same proportion of the total potential recapture tax as the value of the property disposed of or ceased to be used in a qualified use bears to the total value of all property specially valued.

Family Member Definition

The definition of family member for purposes of special use valuation should be amended to include relatives of the decedent's or qualified heir's spouse. This change will permit special use valuation of property left to a decedent's spouse when a brother of the decedent is the farm tenant on the property, for example. This expanded definition of family members is needed to make special use valuation applicable to many small family farming operations.

The definition of family members of a qualified heir should include all persons who are family members of the decedent. This change would make the family member definition more nearly conform to the general understanding of family relationship.

Finally, the definition should be amended to provide that a change in the marital status of an in-law through death, divorce or remarriage will not affect special use valuation eligibility or cause a recapture event.

The revised definition of family members set forth below should apply to estates of decedents dying after December 31, 1982, except that for purposes of the recapture tax the additional family members under the new definition should apply to estates of decedents dying after December 31, 1976.

Section 2032A(e)(2) should be amended to read as follows:

> "(2) MEMBER OF FAMILY -- The term 'member of the family' means with respect to any individual, only --
>
> (A) an ancestor of such individual or of such individual's spouse,
>
> (B) the spouse of such individual,
>
> (C) a lineal descendant of such individual, of such individual's spouse, of a parent of such individual, or of a parent of such individual's spouse, or

(D) the spouse of any lineal descendant described in subparagraph (C).

For purposes of the preceding sentence, a legally adopted child of an individual shall be treated as the child of such individual by blood. The term 'spouse' as used in this paragraph includes widows or widowers, whether or not they are remarried, and also includes former spouses who have been divorced from the decedent, qualified heir, or member of the family to whom such spouse was formerly married, whether or not they are remarried. The term 'member of the family' with respect to any qualified heir of a decedent includes all members of the family with respect to the decedent as determined under the preceding sentences of this paragraph."

Exchanges of Qualified Real Property Between Family Members

The Economic Recovery Tax Act of 1981 added Section 2032A(i) to the Code to exclude exchanges of qualified real property by qualified heirs from recapture tax treatment to the extent that such exchanges qualify under Section 1031 for exemption from capital gains tax treatment. Section 2032A(c)(1)(A) of the Code also exempts dispositions by a qualified heir to his family members from recapture tax treatment. The following new paragraph (4) should be added to Section 2032A(i) to make it clear that Section 2032A(i), and not Section 2032A(c)(1)(A), applies to a Section 1031 exchange between a qualified heir and a family member of the qualified heir, but only to the extent that the application of Section 2032A(i) does not result in the imposition of any tax under 2032A(c).

"(4) EXCHANGE WITH FAMILY MEMBER. -- If an exchange to which this subsection applies could also be characterized as a disposition to a mem-

> ber of the qualified heir's family for purposes of subsection (c), then the terms of this subsection shall apply to the exchange only to the extent that no tax is imposed by subsection (c) as a result of the application of this subsection."

Determination of Fair Market Value of Specially Valued Property

It would be desirable to establish with certainty the amount of the potential recapture tax liability during the audit of the federal estate tax return on which the special use valuation election is made. The calculation of the potential recapture tax amount is based upon the difference between the fair market value and the special use value of the specially valued property on the estate tax valuation date. If the special use value reduction limitation is applicable, then the fair market value of the qualified real property is necessarily determined when the federal estate tax liability is determined. However, in cases where the special use value reduction limitation is not applicable, the federal estate tax liability is not affected by the fair market value of the qualified real property.

The Internal Revenue Service has taken the position that if the fair market value of the specially valued property does not affect the determination of the federal estate tax liability, then the Service can redetermine the fair market value of the specially valued property after a recapture event has occurred. If such redetermination results is a higher recapture tax liability than would result from the fair market value indicated on the federal estate tax return, then the amount of the government's lien for the recapture tax will be insufficient to cover the actual recapture tax liability.

Therefore, it is in the best interests of both the government and the taxpayer to establish a procedure for determining the fair market of the specially valued property as part of the audit of the federal estate tax return. Legislation was introduced in Congress in 1982 to establish a declaratory judgment procedure for this purpose. It would be desirable to enact such a procedure to improve the administration of the special use valuation rules.

The Successive Interest Rule: Remote Interests Passing to Non-Family Members

Treasury Regulation Sec. 20.2032A-8(a)(2) and the IRS interpretation of that regulation have denied the benefits of special use valuation to many family farms. This regulation is generally described as the successive interest rule. Under this rule, the IRS disallows special use valuation for any farm in which a non-family member of the decedent receives an interest, no matter how remote the interest.

For example, in one case the decedent left his farm in a trust for his childrens' lifetimes. Upon the death of the last to die of the three children, the farm is to be distributed to the decedent's grandchildren (five grandchildren were living on the decedent's death). In the event no grandchildren or other descendants are living on the distribution date, then the farm is given to a local charity. The IRS has disallowed the special use valuation election and claimed that $250,000 of additional estate tax is due, even though the actuarial probability that the farm will pass to the charity within the recapture period is .000000000000013! To deny the special use valuation election because of this remote charitable interest is absurd.

It is understood that Treasury may be reconsidering the successive interest rule regulation. Hopefully, some retroactive revision to the regulation will be forthcoming from Treasury in the next few months. However, the Subcommittee should be aware of this problem and should work on a legislative solution to this problem in the event that a more reasonable position is not adopted soon by Treasury and the IRS.

The Illinois State Bar Association would be pleased to render whatever assistance it can to the Subcommittee in developing a legislative solution to the remote interest problem. There are several other technical problems that have arisen under the successive interest rule and some related concepts. It would not be appropriate to discuss all of these technical problems in this testimony. However, these problems should also be addressed at such time as legislative action is deemed necessary to correct the remote interest problem. The ISBA would be pleased to work with the Subcommittee in identifying and resolving these additional technical problems.

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Senator SYMMS. Thank you very much.
Mr. Smith.

STATEMENT OF GERALD C. SMITH, REPRESENTATIVE, THE REDFIELD LAND CO. RENO, NEV.

Mr. SMITH. Mr. Chairman, my name is Gerald Smith. I am a trustee of the Nell J. Redfield trust, the taxpayer for which S. 309 has been introduced. I would like to thank the chairman for the opportunity to speak briefly on behalf of S. 309 this morning.

I have been involved with the Redfield family since 1974. During that period of time I have carried on negotiations with the U.S. Forest Service concerning certain Redfield lands. LaVere Redfield, the husband of the present decedent, died in 1974. His estate included more than 50,000 acres of beautiful, unspoiled forest land lying between Lake Tahoe and Reno, Nev.

LaVere's death did not go unnoticed by the U.S. Forest Service representatives. For years they had been attempting to acquire all or selected portions of the Redfield lands, which lay within the boundaries of the Toiyabe National Forest.

After LaVere's death in 1974, the Forest Service initiated negotiations with Redfield representatives, who expressed a willingness to retain the desired property as a block to allow for the possible acquisition of that property by the Forest Service. By so acting, Redfield voluntarily gave up an opportunity to sell those lands to speculators or developers.

Redfield expressed the desire to work with the Forest Service to preserve the land for the public if at all possible. Negotiations with the Forest Service resulted in legislation in 1976 which enabled the Forest Service to acquire property from the Redfield estate by allowing Redfield a credit against its Federal estate tax liability for the value of the property transferred.

As a result of that initial legislation, more than 28,000 acres of the total 40,000-acre partial originally identified for acquisition by the Forest Service were transferred as a credit against taxes, but more than 10,000 acres of the originally designated property remain for future acquisition.

During the years 1977 to 1981 Mrs. Redfield continued with her negotiations with the Forest Service in an effort to assist the Forest Service in acquiring those properties by appropriation. As evidence of her good faith, she preserved the remaining property as a block in the hope that the transfer could actually be effected. Unfortunately, the Forest Service had no funds available.

Mrs. Redfield died on April 4, 1981. Her death presents a rare opportunity to complete a project started in 1974 by allowing for the acquisition of the remaining property from Nell's estate. Negotiations with the Forest Service have been ongoing since Nell's death. Trustees continue to retain the property as a block to make the transfer to the Forest Service a possibility.

S. 309 has the support of all Nevada agencies and departments of government having any interest in or jurisdiction over the property. Attached as exhibits to our prepared testimony are resolutions of support by the Reno and Sparks City Councils, the Washoe County Planning Commission, county commissioners, the Governor of the State of Nevada, the TRPA, the Nevada State Legislature, and all the congressional representatives whose districts border the Toiyabe National Forest.

This property has a special uniqueness. Three thousand acres of the property lie within the Lake Tahoe basin. Congress has recognized the special quality of those properties by adopting special legislation in the form of the Burton-Santini Act to protect just those certain properties. These properties in general are critical properties which, if not preserved today by use of proposed legislation in the form of this bill, will require protection in future years at great expense to the public.

For the past 10 years, the Redfield family has refrained from attempting to exploit these lands, as it has worked with the Forest Service to enlarge the size and the scope of the Toiyabe National Forest. Redfield has received no direct benefit to date for its efforts.

The alternative available to the estate, Mr. Chairman, would be to exploit the lands by sale to speculators who would destroy the beauty of these forest lands.

S. 309 would make it possible to complete a transfer which has already been approved in principle by Congress in 1976 when it approved the initial legislation. We would respectfully request this committee to approve S. 309. Thank you, Mr. Chairman.

[The statement of Mr. Smith follows:]

COMMITTEE ON FINANCE
UNITED STATES SENATE

Honorable Robert Dole
Chairman
June 27, 1983

SUMMARY OF WRITTEN TESTIMONY IN SUPPORT OF S. 309

PRELIMINARY STATEMENT

On April 5, 1981, Nell J. Redfield, widow of LaVere Redfield, died in Reno, Nevada. The decedent's estate consists of more than 20,000 acres of beautiful, unspoiled forest land in the Sierra-Nevada Mountains, extending from Reno, Nevada, to Lake Tahoe, and generally within the boundaries of the Toiyabe National Forest. A substantial portion of the property lies within the Washoe County Watershed, which is the source of much of the usable water for the residents of Reno and its suburbs.

The Federal estate tax on the Estate of Nell J. Redfield, which is now due and payable, has been calculated to exceed $17 million. The balance of the estate, after payment of certain cash bequests, is distributable to the Nell J. Redfield Foundation, a charitable foundation.

This statement is being prepared by the trustees of the Nell J. Redfield Trust for submission to the members of the Committee on Finance United States Senate at the hearing scheduled for Monday, June 27, 1983.

HISTORICAL REVIEW

Nell J. Redfield ("Nell") acquired the pristene forest land from her husband LaVere Redfield ("LaVere"), who died in Reno, Nevada, in 1974.

Shortly after LaVere's death, representatives of the United States Forest Service (the "Forest Service") contacted representatives of LaVere's estate to determine whether there might be a way to preserve, for the benefit of the general public, some 40,000 acres of forest land which were then owned by LaVere and Nell as their community property. It was believed that a unique opportunity had been presented to several governmental agencies to take united action to preserve the land for the use of the general public. The size of a contiguous tract of land reflecting such exceptional natural beauty created a special condition which might never again be available. The representatives of LaVere expressed a willingness to work with the Forest Service in an effort to preserve the property from development by adding it to the Toiyabe National Forest.

Thereafter, negotiations were commenced to explore avenues that might accomplish the desired result. All of the parties who participated in the initial negotiations between the Forest Service and LaVere's estate believed that if the opportunity to acquire the land by the government was lost, it would be a tragedy which would be justly criticized by future generations.

Numerous alternatives were considered and rejected before the parties determined to seek special legislation which would enable LaVere's estate to transfer property directly to the Forest Service as a credit against its substantial Federal estate tax liability.

As a result of the united effort of the representatives of LaVere's estate, together with the local, state and national representatives and the creative initiative of all the interested parties, IRC § 2204 was added to the Tax Reform Act of 1976. The statute provides as follows:

"Sec. 2304. CREDIT AGAINST CERTAIN ESTATE TAXES.

"(a) In General. -- Subject to the provisions of subsections (b), (c), and (d), credit against the tax imposed under chapter 11 of the Internal Revenue Code of 1954 (relating to estate tax) with respect to the estate of LaVere Redfield, shall be allowed by the Secretary of the Treasury or his delegate for the conveyance of real property located within the boundaries of the Toiyabe National Forest.

"(b) Amount of Credit. -- The amount treated as a credit shall be equal to the fair market value of the real property transferred as of the valuation date used for purposes of the tax imposed and interest thereon under chapter 11 of the Internal Revenue Code of 1954.

"(c) Deed Requirements. -- The provisions of this section shall apply only if the executrixes of the estate execute a deed (in accordance with the laws of the State in which such real estate is situated) transferring title to the United States which is satisfactory to the Attorney General or his designee.

"(d) Acceptance as National Forest. -- The provisions of this section shall apply only if the real property transferred is accepted by the Secretary of the Department of Agriculture and added to the Toiyabe National Forest. The lands shall be transferred to the Secretary of Agriculture without reimbursement or payment from the Department of Agriculture.

"(e) Effective Date. -- The provisions of this section shall be effective on the date of enactment of this Act."

After passage of the legislation, LaVere's representatives and the Forest Service proceeded with its implementation, and on July 27, 1977, LaVere's estate executed a deed transferring some 29,000 acres of virgin forest land to the United States of America as a credit against its Federal estate tax liability.

Completion of the 1977 transfer satisfied a portion of the goal which was established by the Forest Service and representatives of LaVere's estate. However, more than 10,000 acres of land originally identified by the Forest Service as land which should be preserved for the benefit of the public remained in the hands of Nell for future disposition.

In 1978, Nell entered into negotiations with the Forest Service for sale of selected portions of the remaining land. These negotiations terminated when the Forest Service was unable to obtain sufficient funding to complete the acquisition. Notwithstanding the inability of the Forest Service to fund the purchase of the remaining forest land, Nell, as evidence of her continuing good faith, retained the property as a unit in the hope that a way might be found to complete the transfer and thereby reach the lofty goals which had been set in 1974.

THE PENDING LEGISLATION

Nell died on April 5, 1981, in Reno, Nevada. Her estate includes the block of forest land which the Forest Service first identified for acquisition in 1974 but has not yet been able to acquire.

Nell's death has presented the interested parties with the rare second chance to complete the plan conceived in 1974. The estate tax liability in Nell's estate will exceed $17 million and, although the property values have increased dramatically since 1974, utilization in Nell's estate of the procedure originally used in LaVere's estate would enable the Forest Service to acquire substantially all of the remaining land, thereby completing this portion of its program for enhancement of the Toiyabe National Forest.

When presented with this rare second opportunity to preserve a unique piece of America in all its natural and undisturbed beauty for future generations, the Forest Service representatives and Nell's representatives immediately renewed their negotiations. It was determined that new legislation, identical in form to the legislation enacted in 1976, would be needed to allow for a transfer of the remaining property from Nell to the Forest Service as a credit against Federal estate tax liability.

Before seeking any support from representatives in Washington, Nell's trustees first obtained the unanimous support of every state, county and local authority that might have any interest in the proposed transfer. Support was also obtained from the Governor of Nevada, the Nevada Legislature and from the Tahoe Regional Planning Agency. This unqualified expression of support is evidenced by the exhibits attached hereto and incorporated herein.

Special legislation was introduced in the 97th Congress as H.R. 6586 by Representative James Santini, and as S. 2626 by Senator Paul Laxalt, but neither bill was acted upon prior to the end of the session.

On January 31, 1983, an identical bill designated S. 309 was introduced by Senator Paul Laxalt for himself and for Senator Chic Hecht. (A companion bill H. R. 1428 was introduced by Congressman Barbara Vucanovich on February 10, 1983.) The pending bill has received the endorsement of all Congressional delegates from the States of Nevada and California, whose districts border on the Toiyabe National Forest. They include Congressmen Vucanovich and Reid from Nevada and Congressmen Lewis, Chappie and Leyman from California.

From a technical point of view, S. 309 enables the Estate of Nell to transfer to the United States for the benefit of the U. S. Forest Service certain beautiful and unspoiled forest lands lying within or adjacent to the Toiyabe National Forest and to receive as consideration for the transfer a credit against its Federal estate tax liability imposed on the estate which will exceed $17,000,000.00.

The subject property has been reported by the trustees of Nell's estate in the Form 706 Federal Estate Tax Return filed by Nell's estate. In accordance with the provisions of IRS § 2031(a), the property was returned at its fair market value as of the date of death. It thereby becomes a part of the gross estate upon which the Federal estate tax liability has been calculated.

The bill provides that the property to be transferred shall also be valued at its fair market value as of the date of death. In other words, the property shall assume the same value for calculating the credit that it has been given for purposes of imposing the tax liability for which the credit is being received.

The bill is intended to take effect if, and only if, (a) the property to be transferred is accepted by the Secretary of Agriculture and added to the Toiyabe National Forest; and (b) if title to the property is satisfactory to the Attorney General or his delegate.

The following exhibits are attached hereto and shall become a part of the record of these proceedings:

EXHIBITS

1. Resolution of the Reno City Planning Commission supporting legislation dated 5-12-82.
2. Resolution of Reno City Council supporting legislation dated 6-14-82.
3. Resolution of Sparks City Council supporting legislation dated 5-24-82.
4. Resolution of Washoe County Regional Planning Commission supporting legislation dated 5-10-82.
5. Resolution of Washoe County Commissioners supporting legislation dated 5-21-82.
6. Resolution of Tahoe Regional Planning Association supporting legislation dated 6-23-82.
7. Letter dated 5-18-82 from Nevada Governor Robert List to Senator Paul Laxalt expressing support for legislation.
8. Letter to Honorable Peter W. Rodino dated 3-31-83 from Representatives Vucanovich, Reid, Chappie, Lewis and Lehman.
9. State of Nevada Senate Resolution No. 24 unanimously adopted by the Nevada Legislature and signed by Governor Richard Bryan on May 18, 1983.

A map which generally identifies the property in question and highlights its proximity to Lake Tahoe and to Reno has been enclosed in the original of this written testimony for inclusion in the record.

CLOSING REMARKS

This project was blessed in principle by Congress in 1976 when it enacted IRC § 2204 into law. As a result of that legislative effort, much of the forest land identified by the Forest Service for preservation was actually preserved from spoilage. Enactment into law of S. 309 and its counterpart H.R. 1428 will allow for completion of the original project. The pending bill is identical in form to the legislation originally enacted by Congress, except that it applies to the estate of Nell rather than the estate of her husband LaVere. It might be best characterized as an extension of action which was initiated by Congress in 1976. The inducement for Congress to approve this noble endeavor in 1976 is as formidable today as it was then.

The trustees of the Nell J. Redfield Trust respectfully request the members of the Committee on Finance to recommend passage of the pending legislation.

THE NELL J. REDFIELD TRUST

By Gerald C. Smith
Gerald C. Smith
Trustee

Attachments

Council Agenda Item # VII-C-3

AGENDA REPORT
CITY COUNCIL MEETING
June 14, 1982

AGENDA REPORT # 82-317

TO: MAYOR AND CITY COUNCIL

SUBJECT: The transfer of certain forest lands to the U.S. Forest Service as a credit against federal estate taxes due from the Estate of Nell J. Redfield, Deceased

INITIATED BY: City Planning Commission

AGENDA ACTION: Resolution

RECOMMENDATION:

At their regular meeting of May 19, 1982, the City Planning Commission recommended approval of the attached resolution in support of federal legislation authorizing the transfer of certain forest lands in Washoe County, Nevada, to the U.S. Forest Service as a credit against federal estate taxes due from the Estate of Nell J. Redfield, deceased.

BACKGROUND:

In 1974, after the death of LaVere Redfield, special federal legislation was enacted to permit the transfer of some of the Redfield property to the U.S. Forest Service as payment in lieu of cash for federal estate taxes. At that time, the Reno City Council adopted a resolution in support of that action (see attached resolution no. 2994). Since the death of Nell Redfield, LaVere's widow, in 1981, the Redfield Estate proposes once again to transfer land as payment in lieu of cash for federal estate taxes. Lands proposed for transfer are either within the existing boundary of the Toiyabe National Forest or adjacent to it and are identified on the attached map.

The City Planning Commission, by a unanimous vote of the five members present, recommended approval of the attached resolution.

RESOLUTION NO. 2994

INTRODUCED BY COUNCILMAN LEWIS

RESOLUTION TO REQUEST ASSISTANCE FROM FEDERAL AGENCIES IN ORDER TO ACQUIRE LANDS FOR PUBLIC OWNERSHIP, BEING A PART OF THE 55,000 ACRE REDFIELD ESTATE HOLDING ABOVE RENO, NEVADA AND THE LAKE TAHOE BASIN.

WHEREAS, there are certain lands situate in Reno, Nevada and the Lake Tahoe Basin which would have to be sold in order to raise cash for estate taxes; and

WHEREAS, it would be in the best public interest to acquire these lands to be held in public trust; and

WHEREAS, a forced sale to raise cash for estate taxes would place these lands beyond the reach of public agencies; and

WHEREAS, the City Council endorses the approach of urging the Internal Revenue Service to accept the Redfield lands in lieu of cash for Federal Estate Taxes.

NOW, THEREFORE, BE IT RESOLVED by the City Council of the City of Reno, that the Mayor be authorized to send a letter to our Congressional Delegation in Washington, D. C., together with a copy of this Resolution, urging that the Internal Revenue Service accept the Redfield lands in lieu of cash for Federal Estate Taxes, and to hold said land in public trust.

On motion of Councilman LEWIS, seconded by Councilman LIGON, the foregoing Resolution was passed and adopted this 12th day of May, 1975, by the following vote of the Council:

AYES: LEWIS, LIGON, LAURI, BOGART, BIGLIERI, MENICUCCI, DIBITONTO

NAYS: NONE ABSENT: NONE

APPROVED this 12th day of May, 1975.

Sam Dibitonto
MAYOR OF THE CITY OF RENO

ATTEST:
Robin M. Bigiel
CITY CLERK AND CLERK OF THE CITY
COUNCIL OF THE CITY OF RENO, NEVADA.

RESOLUTION NO. 3793

INTRODUCED BY COUNCIL AS A WHOLE

RESOLUTION MEMORIALIZING THE NEVADA DELEGATION IN THE CONGRESS OF THE UNITED STATES TO INTRODUCE AND CAUSE THE ENACTMENT OF LEGISLATION AUTHORIZING THE TRANSFER OF CERTAIN FOREST LANDS IN WASHOE COUNTY, NEVADA, TO THE UNITED STATES FOREST SERVICE AS A CREDIT AGAINST FEDERAL ESTATE TAXES DUE FROM THE ESTATE OF NELL J. REDFIELD, DECEASED.

WHEREAS, previous efforts of the cities of Reno and Sparks, Washoe County and state and federal officers resulted in the enactment of IRC S2204, a part of the federal tax Reform Act of 1976, which authorized the utilization of primitive forest lands in Washoe County owned by the Estate of LaVere Redfield, deceased, as a credit against a federal estate tax liability, thus preserving the land for public use and enjoyment and saving it from commercial and residential development that otherwise might have been necessary to satisfy the federal estate tax claim; and

WHEREAS, on July 27, 1977, the personal representatives of the Estate of LaVere Redfield, deceased, transferred by deed to the United States of America some 29,000 acres of primative forest land as a credit against the federal estate tax liability; and

WHEREAS, Nell J. Redfield, LaVere Redfield's widow, died on April 5, 1981. Her estate includes the remaining acreage identified by the United States Forest Service in 1974 as high priority land but not acquired in the July, 1977, transfer; and

WHEREAS, the City of Reno and other interested parties are again in a position to support Forest Service acquisition of lands valuable for enhancement of the Toiyabe National Forest; and

WHEREAS, the existing legislation for the purpose of accomplishing the desired transfer of Redfield lands to the United States Forest Service was limited to the Estate of LaVere Redfield deceased, IRC S2204 could be amended to include the Estate of Nell J. Redfield, deceased, or a new bill similar to the original bill might be introduced in the Congress for consideration; and

WHEREAS, the Department of Conservation and National Resources of the State of Nevada (including its divisions of Forestry, Water Resources, Parks and State Lands) and the Department of Wildlife of the State of Nevada have approved the proposed exchange;

NOW, THEREFORE, BE IT RESOLVED by the City Council of the City of Reno that:

1. The delegation from Nevada in the Congress of the United States is hereby memorialized to introduce and cause to be enacted appropriate legislation (by amendment of IRC S2204 or a new bill) authorizing the transfer of lands in Washoe County, Nevada, to the Untied States Forest Service as a credit against the federal estate tax liability of the Estate of Nell J. Redfield, deceased; and

2. The City Clerk is hereby directed to transmit immediately certified copies of this resolution to United States Senators Howard W. Cannon and Paul D. Laxalt of Nevada, James D. Santini, Congressman from Nevada, Eugene A. Chappie, Congressman from California, the Chief of the United States Forest Service, Robert List, Governor of Nevada, the Mayor and City Council of the City of Sparks and the Board of County Commissioners of Washoe County, Nevada.

Upon motion of Councilman Pine, seconded by Councilman Scott, the foregoing Resolution was passed and adopted this 14th day of June, 1982, by the following vote of the Council:

AYES: PINE, SCOTT, LEHNERS, SFERRAZZA, BENNETT

NAYES: NONE

ABSTAIN: NONE ABSENT: THORNTON, McCLELLAND

Approved this 14th day of June, 1982.

Barbara Bennett
MAYOR OF THE CITY OF RENO

ATTEST:

CHIEF DEPUTY
CITY CLERK AND CLERK OF THE CITY
COUNCIL OF THE CITY OF RENO, NEVADA

RESOLUTION NO. 1631

Memorializing the Nevada delegation in the Congress of the United States to introduce and cause the enactment of legislation authorizing the transfer of certain forest lands in Washoe County, Nevada, to the United States Forest Service as a credit against federal estate taxes due from the Estate of Nell J. Redfield, deceased.

WHEREAS, Previous efforts of the cities of Reno and Sparks, Washoe County and state and federal officers resulted in the enactment of IRC §2204, a part of the federal Tax Reform Act of 1976, which authorized the utilization of primitive forest lands in Washoe County owned by the Estate of LaVere Redfield, deceased, as a credit against a federal estate tax liability, thus preserving the land for public use and enjoyment and saving it from commercial and residential development that otherwise might have been necessary to satisfy the federal estate tax claim; and

WHEREAS, On July 27, 1977, the personal representatives of the Estate of LaVere Redfield, deceased, transferred by deed to the United States of America some 29,000 acres of primitive forest land as a credit against the federal estate tax liability, thereby accomplishing a part of the objective of the groups that had participated in the successful undertaking; but some 10,000 acres of the land originally identified by the United States Forest Service as high priority lands remained in the hands of the Redfield heirs for future disposition. Nell J. Redfield, LaVere Redfield's widow, died on April 5, 1981. Her estate includes the remaining acreage identified by the United States Forest Service in 1974 as high priority land but not acquired in the July 1977 transfer; and

WHEREAS, The death of Nell J. Redfield provides the City of Sparks and other interested parties with a rare second chance to complete the plan conceived in 1974. By utilizing the procedure adopted by Congress in 1976, the United States Forest Service now has an opportunity to acquire much of the remaining forest lands thereby completing its program for enhancement of the Toiyabe National Forest; and

WHEREAS, The existing legislation for the purpose of accomplishing the desired transfer of Redfield lands to the United States Forest Service was limited to the Estate of LaVere Redfield, deceased, and in order to complete the project commenced in 1974, IRC §2204 could be amended to include the Estate of Nell J. Redfield, deceased, or a new bill similar to the original bill might be introduced in the Congress for consideration; and

WHEREAS, The Department of Conservation and Natural Resources of the State of Nevada (including its divisions of Forestry, Water Resources, Parks and State Lands) and the Department of Wildlife of the State of Nevada have approved the proposed exchange; now, therefore, be it

RESOLVED BY THE CITY COUNCIL OF THE CITY OF SPARKS, NEVADA, That:

1. The delegation from Nevada in the Congress of the United States is hereby memorialized to introduce and cause to be enacted appropriate legislation (by amendment of IRC §2204 or a new bill) authorizing the transfer of forest lands in Washoe County, Nevada, to the United States Forest Service as a credit against the federal estate tax liability of the Estate of Nell J. Redfield, deceased; and

2. The city clerk of the City of Sparks, Nevada, is hereby directed to transmit immediately certified copies of this resolution to United States Senators Howard W. Cannon and Paul D.

Laxalt of Nevada, James D. Santini, Congressman from Nevada, Eugene A. Chappie, Congressman from California, the Chief of the United States Forest Service, Robert List, Governor of Nevada, and the mayor and city council of the City of Reno and the Board of County Commissioners of Washoe County, Nevada.

PASSED AND ADOPTED this 24th day of May, 1982, by the following vote of the City Council:

AYES: Renucci Hastings, Culla, Spanier

NAYS: None

ABSENT: Ainsworth

APPROVED this 24th day of May, 1982, by:

Ronald W. Player

Ronald W. Player, Mayor

ATTEST:

Chloris Goodwin

Chloris Goodwin, City Clerk

STATE OF NEVADA)
)SS
COUNTY OF WASHOE)

I, CHLORIS GOODWIN, City Clerk and Clerk of the City Council of the City of Sparks, Washoe County, Nevada, hereby certify that a copy of City of Sparks Resolution No. 1631,

hereby attached, is a true copy of the original document(s) on record in my office and that I am the duly authorized custodian of the records of the City of Sparks, County of Washoe, State of Nevada.

WITNESS MY HAND AND OFFICIAL SEAL of the CITY OF SPARKS this 24th day of June, 19 82.

Chloris Goodwin

CHLORIS GOODWIN, CITY CLERK and
Clerk of the City Council
City of Sparks, Washoe County, State of Nevada

**REGIONAL PLANNING COMMISSION
OF RENO & WASHOE COUNTY**

RPC

CHAIRMAN
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VICE CHAIRMAN
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Wayne A. Bartels
J. Clark Gribben
R.E. "Skip" Hanson
Walter A. Henderson
Alan Means
W.W. White

EXECUTIVE DIRECTOR
Robert H. Young

M E M O R A N D U M

May 10, 1982

TO: John A. MacIntyre, County Manager

FROM: Michael Lawson-Gilgovan, Planner II, Regional Planning Division

SUBJECT: Resolution Supporting the Transference of Real Estate to the U.S. Forest Service by the Redfield Estate for Payment of Federal Estate Tax

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At its regular meeting of May 4, 1982, the Regional Planning Commission of Reno, Sparks and Washoe County unanimously adopted the above referenced resolution. A copy of the resolution, a memorandum prepared by the Redfield trust in support of that resolution and staff analysis are attached.

Enclosures

Department of Regional Planning of Washoe County / P.O. Box 1331 / 241 Ridge St. / Reno, NV 89504 / (702) 785-4043

OFFICE OF THE WASHOE COUNTY CLERK
COUNTY COURTHOUSE, VIRGINIA AND COURT STS
P. O. BOX 11130, RENO, NEVADA 89520
PHONE (702) 785-6180

JUDI BAILEY
County Clerk

May 21, 1982

Gerald C. Smith, Representative
The Redfield Land Company
P.O. Box 61
Reno, Nevada 89504

Dear Mr. Smith:

I, Judi Bailey, County Clerk and Clerk of the Board of County Commissioners, Washoe County, Nevada, do hereby certify that at a regular meeting of the Board held on May 18, 1982, Chairman Farr issued the following order:

82-609 RESOLUTION - TRANSFER OF PROPERTY - REDFIELD LAND COMPANY - U.S. FOREST SERVICE

The County Manager advised that a Resolution authorizing the transfer of property from the Redfield Land Company to the U.S. Forest Service in payment of estate taxes has been prepared for the Board's consideration.

Russell McDonald, representing the Redfield Land Company, reviewed the history of the impending land transfer to the U.S. Forest Service. He noted that current negotiations stem from the death of LeVere Redfield's wife, Nell; that 10,000 acres of prime forestry land are involved in the transfer in payment of Federal Estate Tax; that taxes generated from these properties is minimum; and that private development of these properties could adversly affect Reno's scenic aspects, water pollution, etc. He cited the amount of taxes generated from this land and noted that this is a small price to pay for this forest area.

On motion by Commissioner Williams, seconded by Commissioner Underwood, which motion duly carried, it was ordered that the following Resolution be adopted, and the Chairman authorized execute on behalf of Washoe County:

RESOLUTION

Memorializing the Nevada delegation in the Congress of the United States to introduce and cause the enactment of legislation authorizing the transfer of certain forest lands in Washoe County, Nevada, to the United States Forest Service as a credit against federal estate taxes due from the Estate of Nell J. Redfield, deceased.

WHEREAS, Previous efforts of Washoe County, the cities of Reno and Sparks and state anad federal officers resulted in the enactment of IRC Subsection 2204, a part of the federal Tax Reform Act of 1976, which authorized the utilization of primitive forest lands in Washoe County owned by the Estate of LaVere Redfield, deceased, as a credit against a federal estate tax liability, thus preserving the land for public use and enjoyment and saving it from commercial and residential development that otherwise might have been necessary to satisfy the federal estate tax claim; and

WHEREAS, On July 27, 1977, the personal representatives of the Estate of LaVere Redfield, deceased, transferred by deed to the United States of America some 29,000 acres of primitive forest land as a credit against the federal estate tax liability, thereby accomplishing a part of the objective of the groups that had participated in the successful undertaking; but some 10,000 acres of the land originally identified by the United States Forest Service as high priority lands remained in the hands of the Redfield heirs for future disposition. Nell J. Redfield, LaVere Redfield's widow, died on April 5, 1981. Her estate includes the remaining acreage identified by the United States Forest Service in 1974 as high priority land but not acquired in the July 1977 transfer; and

WHEREAS, The death of Nell J. Redfield provides Washoe County and other interested parties with a rare second chance to complete the plan conceived in 1974. By utilizing the procedure adopted by Congress in 1976, the United States Forest Service now has an opportunity to acquire much of the remaining forest lands, thereby completing its program for enhancement of the Toiyabe National Forest; and

WHEREAS, The existing legislation for the purpose of accomplishing the desired transfer of Redfield lands to the United States Forest Service was limited to the Estate of LaVere Redfield, deceased, and in order to complete the project commenced in 1974, IRC Subsection 2204 could be amended to include the Estate of Nell J. Redfield, deceased, or a new bill similar to the original bill might be introduced in the Congress for consideration; and

WHEREAS, the department of conservation and natural resources of the State of Nevada (including its divisions of forestry, water resources, parks and state lands) and the department of wildlife of the State of Nevada have approved the proposed exchange; now, therefore, be it

RESOLVED BY THE BOARD OF COUNTY COMMISSIONERS OF WASHOE COUNTY, NEVADA, that:

1. The delegation from Nevada in the Congress of the United States is hereby memorialized to introduce and cause to be enacted appropriate legislation (by amendment of IRC Subsection 2204 or a new bill) authorizing the transfer of forest lands in Washoe County, Nevada, to the United States forest Service as a credit against the federal estate tax liability of the Estate of Nell J. Redfield, deceased; and

2. The clerk of the board of county commissioners of Washoe County, Nevada, is hereby directed to transmit immediately certified copies of this resolution to United States Senators Howard W. Cannon and Paul D. Laxalt of Nevada, James D. Santini, Congressman from Nevada, Eugene A. Chappie, Congressman from California, the Chief of the United States Forest Service, Robert List, Governor of Nevada, and the mayors and city councils of the cities of Reno and Sparks, Nevada.

Very truly yours,

Judi Bailey

JUDI BAILEY, County Clerk
and Clerk of the Board of
County Commissioners,
Washoe County, Nevada

cc: Planning, Assessor, Treasurer, Russell McDonald, Senator Howard W. Cannon, Senator Paul D. Laxalt, Congressman James D. Santini, Congressman Eugene A. Chappie, Harold Bold, U.S. Forest Service, Robert List, Governor of Nevada, Mayor Barbara Bennett, Mayor Ronald Player, City Councils of the Cities of Reno and Sparks

TAHOE REGIONAL PLANNING AGENCY
RESOLUTION NO. 82 - 7

WHEREAS, the Tahoe Regional Planning Agency is concerned with the wise use and conservation of the waters of Lake Tahoe, conservation of the resources in the area around the Lake, and the opportunity for residents and visitors to enjoy the scenic beauty and recreational opportunities of the Lake Tahoe Basin; and

WHEREAS, previous efforts by others to achieve these goals have resulted in the enactment of IRC §2204, a part of the federal Tax Reform Act, permitting transfer of private forested lands from the Estate of LaVere Redfield to the Forest Service as a credit against federal estate tax liability; and

WHEREAS, the Estate of Nell J. Redfield now provides the opportunity for forested land to again be placed in the public domain through amendment of IRC §2204 or introduction of a new bill;

NOW THEREFORE BE IT RESOLVED by the Governing Body of the Tahoe Regional Planning Agency that the delegation from California and Nevada in the Congress of the United States is hereby memorialized to introduce and cause to be enacted appropriate legislation authorizing the transfer of approximately 3,000 acres of forest lands held by the Nell J. Redfield Trust in Placer County, California and Washoe and Douglas Counties of Nevada to the Forest Service, United States Department of Agriculture, as a credit against the federal estate tax liability of the estate of Nell J. Redfield, deceased; and

BE IT FURTHER RESOLVED that executed copies of this resolution be transmitted immediately to United States Senators Alan B. Cranston and S. I. Hayakawa of California and Howard W. Cannon and Paul D. Laxalt of Nevada; Congressmen Eugene A. Chappie of California and James D. Santini of Nevada; the Chief of the Forest Service; and the Governors of the States of California and Nevada.

UNANIMOUSLY PASSED and ADOPTED this twenty-third day of June, 1982, by the Governing Body of the Tahoe Regional Planning Agency.

Date: JULY 14, 1982

Bennie D. Ferrari

BENNIE D. FERRARI, Chairman
Tahoe Regional Planning Agency

May 18, 1982

The Honorable Paul Laxalt
U.S. Senator
326 Russell Building
Washington, D.C. 20510

Dear Paul:

As you will recall, several years ago the State of Nevada endorsed the transfer of pristine forest land located in Washoe County, Nevada from the estate of LaVere Redfield to the United States Forest Service. The State also expressed support for special legislation which would enable the Estate to receive a credit against its Federal Estate taxes for the fair market value of such lands as might be transferred to the Forest Service.

The legislation became effective in January, 1977. In August of 1977, representatives of the Redfield Estate transferred more than 28,000 acres of forest land within the Toiyabe National Forest to the Forest Service in return for a tax credit of almost $11 million.

During its negotiations with Redfield, the Forest Service identified 40,000 acres of Redfield forest lands that it hoped to add to the Toiyabe National Forest. The 1977 transfer accomplished only a part of the desired addition to the Toiyabe and some 12,000 acres remain to be acquired.

Nell J. Redfield, widow of LaVere Redfield, died in April, 1981, and her representatives have expressed a desire to complete the original exchange by transferring approximately 10,000 acres of forest land to the Forest Service.

I feel it is in the best interests of the public to avoid a sale of these fragile lands. The United States Forest Service has expressed its interest in the properties and it is hoped that the proposed transfer can be completed without delay.

I wish to join with many other groups who have endorsed this transfer. Such an action is of great importance to the residents of Nevada, to our state's visitors and to the thousands of citizens who value the natural beauty of northwestern Nevada. To permit this transfer would help complete this project intended to preserve the environmental integrity of one of the nation's most attractive areas.

Sincerely,

ROBERT LIST
Governor

bcc: Gerald Smith ✓
Roland Westergard
John Sparbel

Congress of the United States
House of Representatives
Washington, D.C. 20515

March 31, 1983

Honorable Peter W. Rodino, Jr.
Chairman, House Judiciary Committee
2137 Rayburn HOB
Washington, D.C. 20515

Dear Chairman Rodino:

On February 10, 1983, Mrs. Vucanovich introduced H.R. 1428 which has been referred to your Committee. H.R. 1428 would allow the Secretary of the Treasury to grant credit against taxes owed upon the estate of Nell J. Redfield in exchange for a transfer of prime forest land within and adjacent to the Toiyabe National Forest.

In 1976, special legislation was enacted to enable the estate of LaVere Redfield to transfer forest lands in exchange for a tax credit. The legislation became effective in January, 1977. In August of 1977, representatives of the Redfield Estate transferred more than 28,000 acres of forest land within the Toiyabe National Forest to the Forest Service in return for a tax credit of almost $11 million.

During its negotiations with the Estate, the Forest Service identified 40,000 acres of Redfield forest lands that it hoped to add to the Toiyabe National Forest. The 1977 transfer accomplished only a part of the desired addition.

Unfortunately, that legislative authority does not extend to the estate of Nell J. Redfield, and similar legislation will have to be enacted in order to complete the transfer of Redfield forest lands to the U.S. Forest Service.

We respectfully request that you hold hearings and take action on this legislation as soon as possible. Your consideration in this matter will be most appreciated. Thank you.

Sincerely,

Barbara F. Vucanovich
BARBARA F. VUCANOVICH

Harry M Reid
HARRY M. REID

Gene Chappie
GENE CHAPPIE

Jerry Lewis
JERRY LEWIS

Richard Lehman
RICHARD H. LEHMAN

Senate Joint Resolution No. 24—Senators Wilson, Raggio, Wagner, Mello and Townsend

FILE NUMBER..........

SENATE JOINT RESOLUTION—Memorializing the Congress of the United States to accept land from the Redfield estate in payment of the remaining taxes due on the estate.

WHEREAS, The United States Internal Revenue Service has a substantial lien for estate taxes against property owned by the Redfield estate in and near the Lake Tahoe Basin; and

WHEREAS, If this property were sold for taxes it would be subject to private development which could destroy its scenic beauty, interfere with the ecology, impair recreational use and place severe demands on the resources of the Lake Tahoe Basin; and

WHEREAS, It is imperative that the scenic beauty, natural resources and recreational opportunities of the Lake Tahoe Basin be preserved perpetually; now, therefore, be it

Resolved by the Senate and Assembly of the State of Nevada, jointly, That the Nevada legislature respectfully memorializes the Congress of the United States to recognize the importance of preserving the scenic beauty, ecology and recreational opportunities of the Lake Tahoe Basin by enacting appropriate legislation to accept land from the Redfield estate in payment of the remaining taxes due on the estate; and be it further

Resolved, That copies of this resolution be immediately transmitted by the legislative counsel to the President of the United States, the Vice President of the United States as the presiding officer of the Senate, the Speaker of the House of Representatives, the Secretary of the Treasury, and each member of the Nevada congressional delegation; and be it further

Resolved, That this resolution shall become effective upon passage and approval.

Senator SYMMS. Thank you very much for a very conclusive and excellent statement.

Mr. George Abbott.

STATEMENT OF GEORGE W. ABBOTT, ATTORNEY, MINDEN, NEV.

Mr. ABBOTT. Thank you, Mr. Chairman. I am George Abbott, an attorney with offices at Minden, Nev., which is a county bordering on the south shore of Lake Tahoe. I appear here this morning in support of S. 310 and have been requested by Senator Laxalt to permit him also to submit his statement on this and other pending legislation.

Senator SYMMS. Without objection, his statement will show also.

[The statement referred to follows:]

STATEMENT OF SENATOR PAUL LAXALT ON S. 309, REDFIELD ESTATE BILL
JUNE 27, 1983 AND S. 310

Mr. Chairman:

I appreciate the opportunity to recommend to the Committee my full support of S. 309. This legislation provides for a transfer of 10,111 acres of pristine forest lands to the United States Forest Service as a credit against the estate taxes of the Nell J. Redfield Estate.

The bill culminates extensive negotiations between the Forest Service and representatives of the Nell J. Redfield Estate. It would be a valuable addition to the National Forest lands. Enactment of S. 309 will enable the Forest Service to complete the proposed enlargement of the Toiyabe National Forest by acquisition of the remaining forest lands held by the Redfield family. The transfer would occur through the utilization of a credit against Federal Estate Tax liabilities imposed upon the estate of Nell J. Redfield.

Similar legislation, which was passed in 1976, established provisions for the transferral of 29,000 acres of forest adjoining this tract. The additional land has secured the preservation of this beautiful and untouched area of property. I cannot emphasize enough the necessity of protecting these pristine mountain forests from the unavoidable environmental degradation which would result from development. This similar effort will again prove to be a sound public policy in my opinion and reflect a secure investment for years to come.

The vast natural beauty that encompasses this contiguous tract of land can be protected and preserved. The fragile lands of extremely valuable scenic resources will remain in their natural state.

With the support of this Committee, this immense treasure can be preserved for the future public good.

I also want to present for the Committee's consideration my views in support of passage of S. 310.

This bill provides for the Federal Government to accept 97 acres of the Rabe estate in the Lake Tahoe Basin in lieu of estate taxes.

This is a most unusual circumstance involving a highly important watershed and scenically significant property. The testatrix, Mrs. Rabe, has always intended that the property be in public hands after her death. The property is an isolated private parcel, surrounded on all sides by National Forest. It is highly desirable to the Forest Service that this parcel help complete a manageable bloc of the National Forest.

Mr. Chairman, these lands should be held in public ownership for the good of future generations. It is important to the estate, important to the Forest Service, and beneficial to the United States.

Finally, Mr. Chairman, I would like to mention my strong support for S.B. 953 which is also before you for consideration today. This legislation will allow the decendents of an estate to elect to alter the tax clarification of an estate as long as the estate tax file has not been closed with the IRS. It will alleviate the hardship placed on a particular family who was not aware of changes in the tax laws and did not alter their status forcing them to pay their taxes in one lump sum rather than in several smaller sums. We are not reducing the taxpayers taxes, we are simply asking that their taxes run in line with current tax laws.

Mr. **Abbott.** My own statement is in the hands of Federal Express, which did not necessarily fulfill its commitment on a 24-hour basis.

Since you are a neighbor, Senator, I would like for a moment to orient you to the property we are talking about.

Senator **Symms.** You say this is S. 310?

Mr. **Abbott.** Yes, S. 310.

Senator **Symms.** And this is different property than we just talked about?

Mr. **Abbott.** This is a different property. The House counterpart is H.R. 2389.

I want to begin by saying that the Treasury representative this morning pointed out three conditions, three reasons why they oppose simply exchanging taxpayer property or estate property for taxes. There was a fourth reason given at the May 18 hearing before the House Judiciary Committee, and the Treasury Department said this:

> We believe that if private relief legislation is to be allowed at all in the tax area, it should be limited to the abatement of taxes where there has been a gross injustice for which there is no other possible forum for a hearing for relief.

I suggest that I bring to you such a situation. The decedent died in 1967. After we went to the Tax Court and got a $400,000 reduction in the initial assessment that was accepted on the 706, the tax was $880,000.

By reason of a series of moratoria in this area, the estate has accumulated $4 million in interest penalties and obligations on an initial $800,000. They have paid $1,800,000 so far and today another $1,000 in interest will accumulate. It is $996 or something like that.

This is a NASA photo taken from 85,000 feet. It shows approximately 400 square feet of California and Nevada on the south shore of Lake Tahoe. It also shows by my estimate probably 22 miles of the 80-mile shoreline. The white line here is the division between Nevada on this side and California on this side. The boundary line then goes out about a third of Lake Tahoe. The distance across the lake here is roughly 14 miles. The city of South Tahoe, some 35,000 people, are here. The crest of the Sierra Nevadas, the Eastern Cove, with Job's Peak and the Heavenly Valley ski area, roughly 11,000 feet altitude here, are the watershed division on the California and Nevada side.

The property in question is 97 acres which has been appraised at about $3 million. The remaining tax is $2.6 million. The Forest Service has indicated that they would like to acquire the property under the Burton-Santini Act, but at $1,000 a day, we are not sure that relief is going to come quickly enough.

The property is located 100 yards from property that was worth $25 million, $1 million per acre, conveyed to public entities with the tax benefits that went with that. It is located directly across U.S. Highway 50 from an $18 million piece of property which was donated for public purposes and went with the accompanying tax relief in that instance.

The property is surrounded on three sides now by Forest Service land. What is proposed to be done here is to substitute or to convey this property for the Forest Service or as much of it as would meet the $2,300,000 tax that is due today, and convey it to an agency which has indicated an interest in it.

If ever there seems something that represents a gross injustice, the decedent died in 1967; in 1968 the Tahoe Regional Planning Agency came into existence. For effective purposes, this property was downzoned from 440 residential units to one house if the taxpayer wanted to build then. The alternative, during the moratorium that has been in effect and may still be in effect, although legally it appears to have expired last March, the property was unsauble.

The property is worth, and by an independent appraisal it can surely be established today, at about $30,000 an acre. The reason that the earlier property, including 200 acres across the highway that was conveyed to the Forest Service for $3.9 million, was the decedent had expressed the desire that they either ranch cattle or ranch casinos. They chose to ranch cattle, chose not to turn it into casino property, and if they could do it over again, from the standpoint of the punishment they have suffered, they indeed would do it differently.

I might say that some of the casinos' shadows literally fall on this property, and I believe that either Wayne Newton or the Beach Boys have heard those cattle out in the field, about 150 head of them, or vice versa. Maybe the cattle have heard them.

We think it is a worthy private relief bill, Mr. Chairman. It really indicates some of the horrendous results that can occur when there is not flexibility in a tax law. The property, which at some date has a $3 million value, has been cold storaged while $4 million in tax and penalties accrued, and it is largely through Federal agencies and the determination—we are told that the three Nevada counties and the two California counties—this isn't just a California asset, Lake Tahoe, or a Nevada asset, but it is a national treasure. It is of national value.

We think that the National Treasury could appropriately contribute, and I conclude by saying that California has voted $65 million; Nevada is in the process of voting upward of $40 million to acquire just such watershed interest. The red here, of course, the infrared, shows the watershed areas. It is such a critical area.

I thank you very much for your time, sir.

Senator SYMMS. Thank you very much for a very excellent presentation.

I thank all of you for being here with us this morning. I will say again, the hearing record will be kept open for 30 days for those people who wish to submit testimony. All of your statements will be part of our record.

The committee is in recess. Thank you.

[Whereupon, at 1:25 p.m., the subcommittee was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

June 20, 1983

THE COMMITTEE ON TRUSTS, ESTATES AND SURROGATES' COURTS OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

COMMENTS ON TREASURY PROPOSALS RELATING TO THE GENERATION-SKIPPING TRANSFER TAX

The Committee on Trusts, Estates and Surrogates' Courts of the Association of the Bar of the City of New York (the "Committee") has reviewed the recent Treasury proposals to repeal the existing Federal tax on certain generation-skipping transfers (Chapter 13 of the Internal Revenue Code) and to substitute a new generation-skipping transfer tax. These proposals were submitted on April 29, 1983 by Mr. John E. Chapoton, Assistant Secretary (Tax Policy) of the U.S. Department of the Treasury, to Senator Steven D. Symms, Chairman, Senate Finance Subcommittee on Estate and Gift Taxation.

This is intended to set forth the Committee's comments on these Treasury proposals. Because the proposals recommend repeal of the existing law but include only an outline for a new Generation Skipping Transfer Tax (the "GST Tax"), the Committee will address only the major issues raised by the proposals. More detailed comments on technical issues are not appropriate until the Treasury is ready to present specific legislation.

The Committee believes the Treasury proposals present a substantially new statutory framework for a tax on generation-skipping transfers which poses major new policy questions and complexities. The proposals cannot be viewed as a simplification of existing law. In fact, many serious questions remain unresolved under the present provisions of Chapter 13.

Therefore, the Committee urges the immediate repeal of Chapter 13. Substantial time will be required for the thoughtful and thorough consideration that is required to introduce any workable and sound substitute.

A. The Committee Urges Immediate Repeal of Chapter 13.

The Treasury now admits that Chapter 13 is unworkable and proposes its repeal. As the Treasury proposal notes:

> "The broad scope of Chapter 13, coupled with its extraordinary complexity and the lack of sophistication of many of the lawyers advising those who are subject to the tax, is likely to result in a high level of inadvertant noncompliance and an uneven application of the tax . . . .
>
> The tax is difficult to understand, even for tax practitioners who specialize in estate planning, and can be a major complicating factor in advising clients . . . . "

And finally the Treasury concedes that it is not presently capable of complying with the requirements imposed upon it by Chapter 13:

> "Chapter 13 is also unduly complex from an administrative standpoint. . . . Even assuming the necessary data . . . could be obtained, the information storage and retrieval system required would be extremely costly to maintain and operate."

Since there is now nearly universal agreement among informed parties, including the Treasury, that existing Chapter 13 is unsound and should be repealed, the Committee urges immediate repeal. This should not be delayed pending the adoption of the Treasury's proposals to revise the GST Tax. The Treasury proposes a retroactive effective date for repeal of Chapter 13, but would condition repeal upon the adoption of a new GST Tax. The revisions Treasury proposes are not merely minor adjustments to streamline the existing GST Tax. Instead, the proposals represent a substantially new statutory framework with different objectives and methods of taxation. Moreover, the Treasury proposals leave untouched many of the complexities and other questions which remain unanswered under the existing law some seven years after the original enactment of Chapter 13.

Rather than rush into the adoption of a substantially new form of tax, the Committee would encourage Congress to allow sufficient time for thoughtful consideration of the generation skipping transfer tax system. Is such a system appropriate, and if so, what statutory framework would be workable? It should be noted that an in depth study has been initiated by the American Law Institute, the insights from which should prove useful.

The Committee believes it is inequitable and unjust to leave the present GST Tax in place during the period when a new GST Tax is being considered since abandonment of the present tax seems inevitable. Continued application of the existing GST Tax will perpetuate the high level of uncertainty in estate planning and is likely to make a sham of the compliance process. Unless there is repeal, responsible trustees will be unable to make reasonable decisions. Does a fiduciary who becomes liable for the GST Tax during this period pay it? If he raises the necessary cash by selling appreciated property, does he incur a capital gains tax or is there a step-up in basis?

In the interests of the fairness and integrity of the tax system, Congress should not permit the continuation of an admittedly unsatisfactory GST Tax, even for an interim period, nor should it rush into an ill-considered replacement.

B. Treasury Proposes An Entirely New System of Generation-Skipping Transfer Tax Which Poses Major New Policy Questions.

1. Tax on Direct Transfers. Treasury proposes a GST Tax which would tax direct transfers to beneficiaries at least two generations younger than the transferor. The taxation of direct transfers would be a significant policy

change in the GST Tax. The GST Tax was originally designed to preserve the integrity of the estate and gift tax system by imposing a tax on each generation receiving a beneficial interest in property. Prior to the GST Tax, it was possible for more than one generation of younger beneficiaries to benefit from the same property with only one transfer tax assessed at the time of the original transfer. Or, in the words of the U.S. Treasury Department, Joint Publication Committee of Ways and Means of the U.S. House of Representatives and Committee on Finance of the U.S. Senate, 1969, "The enjoyment of the property by each successive generation is not skipped--it is only the estate tax that is being skipped." (At p. 31.) Now, the Treasury proposes to impose a tax on each generation, whether or not that generation receives any interest in the property.

The reason given by the Treasury for the taxation of direct transfers is twofold. First, the Treasury says it is designed to avoid the "layering" techniques whereby property passes directly to persons two or more generations younger than the transferor. In the Treasury's view, this permits wealthier taxpayers to avoid the GST Tax by making gifts directly to their grandchildren or great-grandchildren whereas less wealthy families cannot afford to bypass their children. Therefore, the Treasury proposes to tax all "transfers which result in the avoidance of the estate and gift tax in one or more generations below that of the transferor."

Second, Treasury claims that this will substantially "simplify" the GST Tax since transfers to persons at least two generations younger than the transferor will be subject to tax, regardless of the nature and extent of any intervening interests of older generations.

Apparently, this tax on direct transfers would apply even where there is no generation in existence to be skipped. Take a simple example: a transferor makes a direct gift to his grandchildren because all his children have predeceased him. The Treasury would subject this direct transfer to the GST Tax even though there are no surviving children actually being skipped.

This proposal creates an entirely new set of problems for estate planning. Consider the usual family arrangement where a trust provides an income interest to the surviving spouse for life, with the remainder to go to the transferor's then surviving descendants. Under present law, no GST Tax would be payable if a child should predecease the spouse and the child's surviving descendants inherit from the trust. Since the child never had a present interest in the trust, the transfer of trust property to his descendants is not considered to "skip" a generation. Treasury proposes, however, to subject this same transfer to the GST Tax.

Similarly, a transfer to a person assigned to a generation two generations younger than the transferor would also be subject to the GST Tax, even if the donee is unrelated to the transferor (e.g., a transfer to a young employee or friend). Query whether it is appropriate to tax direct transfers to beneficiaries two or more generations younger than the transferor who are unrelated?

It is one thing to close a "loophole" which had permitted members of intervening generations to receive all but outright ownership interests in property without being subject to transfer tax on each generation. It is quite another thing to tax all dispositions as if made generation-by-generation.

2. Timing of the Imposition of the GST Tax. The Treasury's assertion that a tax on direct transfers to younger generations "simplifies" the GST Tax ignores the fact that Treasury would make the timing and computation of the tax depend upon whether an older generation beneficiary has an interest in the property. This raises the host of technical rules and problems which exist under the current law and which have remained unanswered in the seven years since its enactment.

Under Treasury's proposal, if a disposition is exclusively for the benefit of persons at least two generations younger than the transferor (whether directly or in trust), the GST Tax will be imposed immediately; if one or more beneficiaries are in older generations, the "old" rules about the timing of taxable distributions and taxable terminations would apply.

For example, if a transferor creates a trust for the benefit of his grandchildren and great-grandchildren, the GST Tax would be due immediately since all the beneficiaries would be at least two generations younger than the transferor. The GST Tax would be computed on the value of the property initially transferred to the trust. If, however, a member of an older generation (such as the transferor's child) is given an interest in the same trust, then the payment of the GST Tax would be postponed until distributions to the grandchildren or great-grandchildren or until the termination of all the interests of older generation beneficiaries. In this case, the GST Tax would be imposed on the value of the property remaining in the trust at the time of such termination.

Thus, it will continue to be necessary to determine whether members of an older generation have an interest in trust property in order to determine when the GST Tax is imposed and the proper tax base. This raises many of the problems which exist under the current statute. If an interest given to an older generation beneficiary is de minimis, should that be permitted to postpone the imposition of the GST Tax? Is the ability to use the property to satisfy a support obligation of an older generation beneficiary (such as the ability to use property held for a minor under the Uniform Gifts to Minors Act to discharge a parent's support obligation) a beneficial interest in property sufficient to cause postponement of the GST Tax? Are estates and custodianships generation-skipping equivalents?

3. Computation of the GST Tax. Under the Treasury proposal, the existence of interests of older beneficiaries will affect not only the timing but also the base upon which the GST Tax will be imposed. Any GST Tax which is deferred will be imposed upon the gross amount of property subject to tax while a transfer subject to immediate GST Tax will be taxed on property net of the GST Tax due.

Consider the example of a transferor with an estate of $2,000,000. Our transferor has one child and four grandchildren. If he gives property directly to his grandchildren, the GST Tax would be due immediately. (The same would be true if he creates a trust in which his child has no interest so that the oldest generation of beneficiaries are grandchildren.) Here, the GST Tax will be payable only on the net amount of the property transferred to or in the trust for the grandchildren (that is, the amount left after the payment of the GST Tax).

On the other hand, if our transferor creates a trust in which his child has an interest, the payment of the GST Tax would be postponed until distributions are made to the grandchildren or until the child's interest terminates. Here, the gross amount of the property in the trust will be subject to the GST tax (not merely the net amount received by the beneficiary).

Thus, the transferor's decision will be heavily influenced by judgments about the comparative advantage of paying the tax "up front" on a net transfer or having the tax deferred and assessed on the gross funds actually distributed.

Furthermore, if he creates a generation-skipping trust that continues for the benefit of his grandchildren and great-grandchildren (or longer, if local trust law permits) he will pay a GST Tax only once, on the net value of the trust at the time of creation. If the trust is properly structured, there will be no further GST Tax or estate tax until the termination of the trust, even though the property benefits more than one younger generation of beneficiaries. On the other hand, if he gives property directly to his grandchildren that property will be subject to estate tax in each grandchild's estate, again in each great-grandchild's estate, and so on.

These new proposals, then, may actually encourage the creation of long-term trusts which skip several generations.

4. Liability for the GST Tax. Treasury would assess the GST Tax against the property subject to tax; in some cases, only the net amount would be included in the tax base, as discussed above. If a transferor pays the GST Tax, he will be deemed to be making an additional gift to the extent of the GST Tax.

In other words, the gift would be grossed-up to reflect the payment of the GST Tax, giving rise to further gift tax. Thus, a gift of $1,000,000 subject to a GST Tax of $400,000 which is paid by the transferor would be viewed as a gift of $1,400,000. The total tax bill on the gift of $1,000,000 would be $1,100,000 ($400,000 of GST Tax plus gift tax of $700,000, assuming a 50% bracket), or 110% of the amount received by the donee. Query: does this spiral of gross-up continue so that the $400,000 of GST Tax is in turn an additional generation-skipping transfer subject to further GST Tax, thereby constituting a further gift, and so on?

5. Income Distributions Subject to Tax. The present law excludes income distributions from the GST Tax since the Treasury had originally hoped to avoid the complexity that would otherwise ensue. Now, Treasury proposes to apply the GST Tax to income distributions but to grant the distributee an income tax deduction for the amount of the GST Tax imposed.

In advance of specific legislation, it is only possible to highlight some of the potential problems. Where there are multiple trust beneficiaries who have received current income (especially where distributions are to older generation beneficiaries and thus are not generation-skipping), it will be difficult to allocate the deduction for the GST Tax among them and to make any appropriate equitable adjustments.

Transferors and trustees may be able to structure trust receipts as income (as opposed to principal) and to invest trust assets so as to maximize the benefit of the deduction for the GST Tax even where such decisions would not otherwise make sense. This could also pose allocation problems among the trust beneficiaries since (i) the definitions of the "income" a distributee receives for income tax purposes and under local trust law are not necessarily the same, and (ii) some income (such as capital gains) is taxed at special rates while other income (such as interest on municipal bonds) is not taxed for Federal purposes at all.

6. Effective Date and Other Issues. The effective date provisions are similar to those in the present law, and will recreate the attendant problems, including questions regarding subsequent additions to "grandfathered trusts" and constructive additions.

Finally, Treasury's proposals give no evidence of addressing a number of other important problems which exist under the current law. These include the proper ascertainment of generation (including the appropriate treatment of step-parents and step-children), generation-shifting, the identification of the transferor (especially when the transferor is a trust or corporation or where there are multiple transferors), the interaction of the various postponement rules, the interaction of the GST tax with the charitable deduction, etc.

7. An Exemption of $1,000,000 Is Not A Cure. Treasury asserts that the solution to many of the problems discussed above, as well as the unresolved problems under existing law, is the adoption of an exemption of $1,000,000 per taxpayer. While it may be true that this would exempt a great number of taxpayers from the possible application of the GST Tax, it fails to address or cure the problems inherent in the existing law or the proposed changes.

Although the exemption apears to be similar to the pre-1977 gift tax specific exemption, it will be much more complex in operation. Treasury proposes that each individual be given a lifetime exemption from the GST tax of $1,000,000. A married transferor may (with his spouse's consent) use his spouse's exemption. An election would be made to apply the exemption to a specific transfer in trust either at the time of the initial transfer or at any time thereafter; an executor would be able to apply the unused portion of a decedent's exemption at his death.

For the reasons discussed earlier, it may be difficult for a transferor to know if a given transfer is generation-skipping when made. An untimely order of deaths can cause an unintended skip, as when a child dies before the termination of a trust, causing a gift over to that child's descendants which becomes subject to the GST Tax. This may make it difficult for a transferor (or his executor) to select the transfers for which the exemption should be elected and allocated.

If a trust exceeds the available exemption, it will be only partially exempt from GST Tax. The problems of administering such a trust and the required record keeping will be burdensome. The Treasury anticipates that many transferors will divide their assets into wholly exempt and non-exempt trusts. However, there will be many situations in which such a cure is not readily attainable. For example, a transferor may have to limit the number of trusts he creates in order to avoid multiple trust problems for income tax purposes. Also, if a transferor has an estate which does not substantially exceed the exemption, it may not be economic (because of administration costs) to create both exempt and non-exempt trusts.

A transferor and spouse having combined estates of $2,000,000 could, Treasury states, transfer the entire $2,000,000 free of GST tax under the proposals. This will only be true if both spouses make substantial gifts or die with estates of at least $1,000,000 of assets which create potentially generation-skipping transfers. If a transferor would prefer to leave all his property to his spouse outright, he will lose his $1,000,000 exemption. Alternately, if one spouse owns all of the property and the other spouse dies first, the decedent's $1,000,000 exemption would be lost. Here again, Treasury's proposals may be encouraging the creation of long-term trusts.

A tax which has been widely hailed as impossibly complex to understand and administer poses grave concerns about the integrity of the tax in our self-assessment system. The current GST Tax is such a tax and the Committee does not believe an appropriate answer is to create large exemptions so as to limit these negative consequences to fewer individuals. Instead, the Committee believes that any GST tax should be workable, fair and understandable.

CONCLUSION

That the present Chapter 13 is incapable of being administered and implemented has now been recognized by the Treasury, taxpayers and the practising bar alike. The Treasury's proposals represent a fundamental change in the nature and scope of the GST Tax; they do not present a cogent legislative package susceptible of prompt enactment. The proposals are vague on many important components of a new statutory structure and would create a wealth of new problems without addressing a number of unresolved issues under the current law.

The case for immediate, retroactive repeal of Chapter 13 is compelling. Consideration of a new tax on generation-skipping transfers should proceed as part of a fresh, careful and complete look at the entire area.

Respectfully submitted,

THE COMMITTEE ON TRUSTS, ESTATES
AND SURROGATES' COURTS

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June 16, 1983

Mr. Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-221
Dirkson Senate Office Building
Washington, D.C. 20510

Dear Mr. DeArment:

This letter is written in connection with your invitation for public comment prior to hearing on several Federal Estate and Gift Taxation reform and change bills which are up for hearing on June 27.

Some of the difficulties which these bills address and difficulties which have arisen in the past causing other amendments to the law, arise out of the fact that the Federal Estate tax return is required to be filed in nine months. No, repeat no, estate which is complicated enough to be subject to Federal Estate tax can be settled in nine months and thus when the return is filed no one really knows what elections should or should not be made.

Up until Lyndon Johnson's administration Executors were allowed fifteen months to file a Federal Estate tax return which was just about right. By that time everything could be worked out and there was no excuse for having to come back and file either late returns or amended returns. This was changed when President Johnson reduced taxes, started a war, and launched his Great Society all in one year. The purpose of reducing the time to nine months was to speed up collections in that one year and thus reduce the size of the deficit. The result has turned Federal Estate tax return preparation into a rat race ever since.

The committee should give serious consideration to restoring the filing time to fifiteen months after death. If this were done many of these other vexing problems will automatically solve themselves.

Very truly yours,

Robert Bracken

RB/pb

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June 16, 1983

Roderick A. DeArment, Chief Counsel
Committee on Finance, Room SD-211
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Hearings of Senate Finance Subcommittee
on Estate and Gift Taxation

Dear Mr. DeArment:

I am the staff research attorney for the Estate Planning & California Probate Reporter. The Subcommittee's recent hearing announcement requested suggestions for modification of the rules governing special use valuation. In monitoring IRS Rulings for our publication, it has become apparent that the Service is construing a portion of IRC §2032A in a manner which is starting to produce some rather bizarre rules, traps for the taxpayer, and no conceivable justification in terms of public policy (assuming one's version of public policy is not to simply repeal the entire statute.)

The problem relates to use of specially valued property by the heirs in the post death period. IRC §2032A (c)(1)(B) provides for recapture of estate tax if the qualified heir fails to use the property for a qualified use. IRC §2032A (c)(6)(B)(ii) permits the post death "material participation" requirement to be met by a member of the qualified heir's family. This permits a son to run a farm belonging to his elderly widowed mother. Similarly, a brother can run a farm, half of which was inherited by his sister who now lives in the city. At least, its reasonable to assume that that is what Congress intended.

When these intrafamily arrangements are made, it is usually the case that the most sensible financial arrangement between the qualified heir owner and the operating family member is a lease of the property. Unfortunately, the Service has adopted a construction of the statute which makes this impossible. The construction is now breeding correlaries which have begun to border on the absurd in terms of congressional intent. In the latest ruling, the Service borrowed the tax shelter concept of being "at risk" to apply to the intrafamily financial arrangement problem. The situation is so bad, that we have advised our readers to obtain individual rulings in every case.

The gory details of all this are contained in the marked excerpts from our publication, which I am enclosing. IRC 2032A(c)(B) should be amended to make clear that the qualified heir is using the property for a qualified use if the person meeting the material participation requirement is using the property for a qualified use.

Very truly yours,

Jeffrey Dennis-Strathmeyer

JD-S:dp
Encl.
cc: Hon. Leon E. Panetta

cc: Office of the Assistant
Secretary for Tax Policy

P.S. The opinions expressed herein are personal and do not reflect a position by California Continuing Education of the Bar.

CALIFORNIA CONTINUING EDUCATION OF THE BAR

ESTATE PLANNING & CALIFORNIA PROBATE REPORTER

Volume IV, Number 4, February 1983

HIGHLIGHTS

75 **The Inheritance and Gift Tax Sequel**
Changes in California probate administration and the role of California probate referees are discussed by Albert J. Nicora.

77 **Federal Estate Tax**

81 **Federal Gift Tax**
81 *Dickman v Commissioner*
The Eleventh Circuit found that interest free demand notes are taxable gifts, criticizing the rulings of the Tax Court and the Seventh Circuit in *Crown.*

82 **Federal Income Tax**
84 *LaFargue v Commissioner*
Trustor's purchase of an annuity from the trust is not retention of an income interest.

85 Subchapter S Revision Act of 1982
Estate planning implications discussed.

88 **California Developments**

89 **Et Cetera**

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Simple Probate-Avoidance Trusts: Higher Stakes and Old Problems

by Jeffrey A. Dennis-Strathmeyer*

Recent and proposed legislation is likely to increase the use of simple probate-avoidance trusts (SPATs) as "will substitutes." The Economic Recovery Tax Act of 1981 (ERTA), which increased the federal estate tax unified credit, and the abolition of the California inheritance tax, have substantially increased the number of estates free of death tax considerations. In addition, Resolution 1-4-82, approved in principle by the Conference of State Bar Delegates, proposes legislation to remove doubt regarding the validity of a trust in which a trustor is the trustee of a trust established primarily for the trustor's own benefit.

As the SPAT is used in larger estates, its inherent weaknesses are magnified. Unlike the simple will which it replaces, this type of trust has not had the benefit of hundreds of years of legal evolution to resolve a multitude of potential problems involving, for example, the effect of various dispositive provisions and the rights of creditors. Furthermore, even a "simple" trust is not simple: It is a sophisticated device which must be adapted for use by the frequently unsophisticated client who is otherwise a candidate for a simple will and whose estate plan may not be regularly reviewed by a professional. Finally, there are distinct economic limitations on the amount of custom drafting that can be done in preparing an instrument with no other economic benefits than avoidance of probate and conservatorship.

As a result, the drafter of a SPAT is confronted with a situation closely akin to that of a designer of a color television receiver. Faced with extensive technical problems, he must produce a product that is (1) simple to use, and (2) safe for use by an unsophisticated consumer who may negligently maintain it. This article reviews some of the more significant technical problems involved in drafting SPATs and suggests approaches for solving those problems.

---

*Jeffrey A. Dennis-Strathmeyer is a research attorney at CEB. He received his A.B. from Stanford University in 1967 and his D.Jur. from the University of California at Davis in 1973.

The Simple Probate-Avoidance Trust

To facilitate this discussion, a SPAT is restrictively defined as an inter vivos trust having the following characteristics:

1. The trust may be amended or revoked, in whole or part, at any time;
2. The trust's primary purpose is to avoid probate;
3. A secondary purpose of the trust is to avoid conservatorship;
4. The trustor acts as trustee until resignation, incompetence, or death;
5. No beneficiary other than the trustor has any right of possession or other enjoyment of an interest in the trust estate until the death of the trustor;
6. The trustor's estate, including life insurance and qualified retirement plan benefits in excess of the $100,000 federal estate tax exemption (IRC §2039(c)), is too small to be subject to federal estate tax; and
7. In the case of a trust established by a married couple, the survivor continues to have full power of revocation and amendment after the death of the other spouse, including the power to receive the trust estate free of trust.

The SPAT, under this restricted definition, is not a device for saving taxes. Indeed, its use involves forgoing the income tax benefits of a probate estate. Accumulated income taxed to a probate estate is not subject to the throwback rules on later distribution. With careful selection of a tax year, significant income tax savings can be produced in probate estates having income-producing property and high tax bracket heirs. See Estate Planning for the General Practitioner §10.51 (Cal CEB 1979). In the case of a married couple, further adverse tax consequences may result if the trust is not carefully drafted to preserve the community character of property transferred to it. The survivor may lose the benefit of obtaining a stepped-up basis in the survivor's half of the community property (IRC §1014(b)(6)). See Drafting California Revocable Inter Vivos Trusts §4.40 (Cal CEB 1972). Counsel should be especially careful when transferring community property in joint tenancy form to the trust. Either the trust declaration or the conveying instrument should confirm the community property character of the property.

The Trust Validity Problem

It must be noted that there are unresolved theoretical issues involving whether the SPAT described above is a valid trust. At least in theory, this trust is vulnerable to the argument that, when a trustor-trustee retains too many rights and powers over the trust estate and is the only beneficiary during his lifetime, the trust is a testamentary instrument that does not comply with the requirements for a formal witnessed will (Prob C §50). When this theory is applied, the remainder interest is not recognized because of the failure to comply with statutory testamentary formalities and the trust becomes invalid under the merger doctrine because the sole beneficiary is the sole trustee.

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Nutter, reported at p 87, there was a substantial failure to introduce evidence on the issue of value. With the testimony of a friendly expert, the petitioner could have argued for a date of death valuation in the $15,000-20,000 range based on admitted evidence establishing (1) that the wife's share of the future recovery became very limited on her death because it ended the time period for which she suffered loss of support and consortium, (2) the actual net settlement was a reasonable measure of the value of the original claim, and (3) that the $49,000 settlement should have been discounted for five years of inflation and postponed enjoyment.

IRC §2032A: Special Use Valuation

Estate's net lease of farmland to decedent's children results in imposition of recapture tax.

IRS Letter Ruling 8240015 (June 29, 1982)

Decedent, who owned a one-half interest in farm real property, died in 1978. Under the terms of the will, the farm would pass to either the surviving spouse or their children depending on the executor's allocation of property under a formula marital deduction clause. No allocation has been made. The executor elected to specially value the farm property under IRC §2032A, and made a net lease of the farm property to the children who are qualified heirs under §2032A(e)(1).

In the Service's analysis, the lease arrangement between the estate and decedent's children could be seen as two distinct and separate arrangements. To the extent the estate is leasing the property on behalf of the children as beneficial owners to the same children, the lease is a wash transaction with no tax consequences. The children are in effect leasing the property to themselves. On the other hand, to the extent that decedent's estate is leasing the property for cash to decedent's children on behalf of the surviving spouse, the transaction represents a net rental between a qualified heir and a member of his family. According to the ruling, this results in imposition of the recapture tax because a net rental is not a use by a qualified heir under §2032A(c)(1)(B).

The Service further ruled that because all the specially valued property may ultimately pass to the surviving spouse (at the discretion of the estate's representatives), all of the farm is subject to recapture tax.

Comment: The ruling, although poorly written, must be accepted as stating that the IRS takes the position that, in the postdeath period, the qualified heir who received the real property must personally continue the qualified use. In spite of the IRS position, it is difficult to reconcile this ruling with the statute. The ruling relies on IRC §2032A(c)(1)(B), which imposes the recapture tax if the qualified heir ceases to use the property for a qualified use. The ruling ignores the language of §2032A(c)(6)(B)(ii), which provides that recapture occurs when, "in periods during which the property was held by any qualified heir, there was no material participation by such qualified heir *or any member of his family* in the operation of the farm or other business." [Emphasis added.] It seems that application of §2032A(c)(6)(B)(ii) would require the conclusion that, in this ruling, operation of the farm or business by the surviving spouse's family through a net lease arrangement would constitute material participation preventing imposition of the recapture tax.

In support of the IRS conclusion, it may be argued that the language of §2032A(c)(6)(B)(ii) covers only the situation in which the qualified heir has an interest in the operation of the property as a farm or other business but the actual participation in that operation is carried out by other members of the family. Under the facts of this ruling, the surviving spouse arguably had no interest in the operation of the property as a farm or business; he was simply an owner receiving a net cash rental.

Regardless of the accuracy of the IRS conclusion, it is obviously unsafe to advise the client to lease the property within the family until the ruling is clarified.

IRC §2036: Retained Life Interest

Extrinsic evidence admissible to determine whether trustor reserved right to name herself as successor trustee.

Estate of Ruth T. Reid (1982) 44 CCH TCM 1137, P-H Tax Ct Mem Dec ¶82,532

The trustor of an irrevocable trust reserved the right to name a successor trustee if the corporate trustee resigned. The instrument contained no language indicating whether the trustor reserved or renounced the power to name herself as the successor trustee. If she had such a power, she retained control over distribution of the trust, which would result in its inclusion in her estate under IRC §2036(a)(2). Testimony of the attorney who drafted the instrument and the son of decedent indicated decedent never intended to reserve to herself the power to appoint herself as successor trustee. The government objected to their testimony on the grounds that, under the Texas dead man statute, each was incompetent to testify. Both witnesses were coexecutors of the estate, although the attorney had resigned before his testimony in the case.

The court held that the attorney was competent to

CALIFORNIA CONTINUING EDUCATION OF THE BAR

ESTATE PLANNING & CALIFORNIA PROBATE REPORTER

Volume IV, Number 5, April 1983

Page 93

HIGHLIGHTS

99 **The Inheritance and Gift Tax Sequel**
Proposition 6 survives court test.

100 **Federal Estate Tax**

104 **Federal Gift Tax**
105 Rev Rul 83-26
Spouse's subsequent disclaimer of trust income invalidates executor's QTIP election.

106 **Federal Income Tax**
106 *Estate of Margita Applestein*
Assignment of income doctrine applied to gift of securities of merger candidate.

111 **California Developments**
113 *Wells Fargo Bank v Town of Woodside*
Local subdivision ordinance conflicts with probate homestead law.

114 **Et Cetera**
114 Estate and Gift Tax Provisions of the Technical Corrections Act of 1982

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Interest-Free Loans in a Time of Uncertainty

by Owen G. Fiore

The increased time value of money in recent years has resulted in wide and varied use of interest-free intrafamily loans and corporate executive loans as a means of transferring capital without cost. Such loans can provide the borrower with a source of income taxed at an effective rate lower than the lender's marginal rate. They also give the borrower an opportunity to create new capital through investment of the loan proceeds. The intrafamily loan has often been used as part of an overall program for allocating investment opportunities and assets among family members; in addition, many corporate executives have utilized both family and corporate interest-free loans as a significant part of an estate planning program.

Attorneys asked to give advice on interest-free loans have an obligation to fully apprise their clients of the tax risks involved in an area where the tax law is unsettled. Indeed, what may prove to be the landmark gift tax case in this field is now pending before the U.S. Supreme Court. *Dickman v Commissioner* (11th Cir 1982) 690 F2d 812, cert granted Feb. 22, 1983, No. 82-1041, 51 USLW 3599. Counsel must also be prepared to assist clients in evaluating the economic benefits which must be balanced against the risks. If, after this review, the client believes the benefits outweigh the risks, the attorney must structure and document the actual transaction in a manner which reduces the client's risks to the maximum extent possible.

This article reviews the benefits of these loans and the nature and extent of the tax risks. It also presents sample documentation for corporate executive loans.

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distinct discounts, although they may overlap in many circumstances. However, in this case the distinction was not considered crucial, because the issue was whether the fact that all the remaining stock was held by close family members meant the discounts would not be available at all. The Tax Court concluded that such discounts are available in family corporations, expressly approving the holdings of the Fifth Circuit in *Bright v U.S.* (5th Cir 1981) 658 F2d 999 and of the Ninth Circuit in *Propstra v U.S.* (9th Cir 1982) 680 F2d 1248. The Tax Court distinguished three other decisions on the grounds that one was too old, one involved a unique situation where there was a planned sale of all the stock in the family corporation, and the third apparently assumed the stock could have been sold to a third person at the disputed value.

Putting all this together, the court noted with some apparent impatience that this is the kind of case best settled by negotiation. It then considered all the valuation reports of the various experts, and all other relevant factors such as conservative business attitudes and management practices, the types of real property holdings, cash, and other liquid assets held by the corporations, and the business climate on the valuation date. Because of their restricted marketability, the court also discounted the shares. It then assigned values to the shares without indicating how the values were actually computed.

IRC §2032A: Special Use Valuation

Family members' exchange of interests in qualifying real property through the use of a straw man will not result in recapture; if qualified heir may lease farm from other qualified heir.

IRS Letter Rulings 8304100, 8304106, 8304107 (Oct. 27, 1982)

Six members of the same family own property valued under IRC §2032A which they inherited from two decedents. This property has been leased to one of the qualified heirs and is farmed by him. The heirs propose to partition their undivided interests by deeding their interests to a straw man who will then deed the properties back to the heirs in the manner desired. All parcels will continue to be leased to the qualified heir who actively farms the land.

After first ruling that the use of the straw man does not affect the qualification of the exchange as tax free under IRC §1031(a), the Service further held that, because the ultimate disposition of the property in this case would be to qualified heirs, there would not be a federal estate tax recapture.

Comment: In this case, all the heirs are "qualified heirs" and each is a "member of the family" of each of the others. By implication, the ruling holds that a cash lease by five of the heirs to the sixth does not result in recapture of federal estate tax. However, compare IRS Letter Ruling 8240015 (June 29, 1982), reported at 4 CEB Est Plan R 78 (1983), which held that a lease by an executor to the children of land passing to a surviving spouse resulted in recapture. The Reporter's comment suggested that the ruling was "difficult to reconcile with the statute." Until the confusion is clarified, counsel should consider obtaining a ruling from the service before permitting intrafamily cash leases in the post-death period.

About IRS Letter Rulings

Private letter rulings are issued by the IRS on certain issues if requested by the taxpayer. See Rev Proc 80-20, 1980-1 Cum Bull 633; Rev Proc 80-21, 1980-1 Cum Bull 646; Rev Proc 81-33; 1981-32 Int Rev Bull 19; Rev Proc 82-22, 1982-13 Int Rev Bull 16; Rev Proc 83-1, 1983-1 Int Rev Bull 16. The letter ruling may not be cited as authority by anyone other than the recipient. This Reporter will digest significant letter rulings as space permits.

The number of the letter ruling may be used to locate the full text of the ruling in several commercial publications. The number indicates the year (first two digits) and week (second two digits) in which the ruling was released by the IRS. This date is generally three to four months after the date the ruling was actually written, which is the date supplied in the citation.

Readers may obtain copies of any letter rulings by writing to the Freedom of Information Reading Room, Internal Revenue Service, Attention: TX: D: F: RR, 1111 Constitution Avenue, Washington, D.C. 20224. There is a charge of 10 cents per page with a minimum of $1.00.

Trustee's discretion to distribute farm property to a trust in which no qualified heir has a present interest prevents special use valuation.

IRS Letter Ruling 8244001 (Jan. 14, 1982)

Otherwise qualifying real property was transferred to a revocable trust providing that on decedent's death the corpus would be divided into two separate trusts, designated Trust A and Trust B. Trust A was a power of appointment marital deduction trust for the spouse; Trust B was a bypass trust in which the trustee had absolute discretion to accumulate income or allocate income or principal between decedent's widow and children.

Relying on the requirement in the Tax Reform Act of 1976 (Pub L 94-455, 90 Stat 1520) that a qualified heir must have a present interest in the trust in order for the property to be considered to pass to a qualified heir, the Service noted that allocation of the property to Trust B would disqualify it. Because it could not be determined on date of death whether the property

CALIFORNIA CONTINUING EDUCATION OF THE BAR

ESTATE PLANNING & CALIFORNIA PROBATE REPORTER

Volume IV, Number 6, June 1983 Page 117

HIGHLIGHTS

119 **The New California Estate Tax Return**
Is the Controller illegally overtaxing multistate estates?

123 **Federal Estate Tax**
125 IRS Letter Ruling 8314005
Estate entitled to marital deduction for full fair market value of special-use valued farm.

129 **Federal Gift Tax**

130 Rev Rul 83-35
Creator of joint tenancy makes gift when he disclaims after death of other joint tenant.

130 **Federal Income Tax**
134 Prop Reg §§1.6661-1—1.6661-6
Service proposes substantial understatement regulations.

136 **California Developments**
136 *Estate of Carpenter*
Deed to self terminates joint tenancy.
138 Urgency Legislation

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Rights of Adopted Persons in California Estates and Trusts

by John N. Leutza and Diane M. Roth

In recent years it has become progressively clearer that the law pertaining to the identification of "children" and "issue" for purposes of distribution of estates and trusts has failed to keep pace with social trends. This is particularly true in cases involving the law of adoption or equitable adoption. Consecutive marriages and stepparent families are now extremely common. These social phenomena result in an increased frequency of situations in which relationship by blood does not necessarily coincide with either legal or emotional relationships. Consider, for example, the complexities of a situation in which a stepfather has adopted a child who still maintains warm ties with the natural paternal grandparents.

This article examines the law of adoption and equitable adoption in the context of rights of succession, pretermitted heirship, and the construction of dispositive instruments. Although it remains the general rule that adopted children inherit from their adopting parents and not their natural ones, the rule is riddled with exceptions posing numerous problems for the estate planner. These problems are aggravated by the fact that the critical events determining the identification of distributees frequently do not occur during the life of the client. The article will present sample clauses to suggest ways in which planners may circumvent the pitfalls described. Certainly the day is long past when the careful draftsman can rely on the simple traditional recital to the effect that the words "children" or "issue" as used in the will include persons legally born to or adopted by the testator.

Adoption and Intestate Succession

The one area in this field clearly dealt with by statute is the effect of adoption on the law of intestate succession. Probate Code §257 pro-

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decedent failed to pay self-employment tax. The estate may overcome the presumption by proving material participation and paying any self-employment tax, interest, and penalties determined to be due.

In this case the executor sought to establish material participation for the five years immediately preceding death. Decedent had timely filed Form 1040 each year. As a result, the limitations period had run for self-employment tax due in the first two years.

Relying on IRC §6401(a), which provides that the term "overpayment" includes payment of a tax after the limitation period expires, this ruling holds that the executor is not required to pay the self-employment tax for the barred years.

Personal property of unrelated business cannot be aggregated with farm assets to meet 50 percent test.

Estate of Walter H. Geiger (1983) 80 TC No. 20, CCH Tax Ct Rep Dec 39,936, P-H Tax Ct Rep Dec ¶80.20

Forty-two percent of the adjusted value of decedent's gross estate consisted of real and personal property used for farming. Eleven percent consisted of a wholesale hardware business. Internal Revenue Code §2032A(b)(1)(A) prohibits special use valuation unless at least 50 percent of the adjusted gross estate consists of real or personal property used for a qualified use. The estate contended that it was entitled to aggregate the hardware business with the farming business for the purpose of meeting the 50 percent requirement.

The Tax Court ruled in favor of the Service. Although the language of the statute is unclear, IRC §2032A only refers to personal property in connection with real property. In view of the purpose of the statute, and the context of the phrase, it appears that Congress intended to restrict the personal property which could be used to meet the 50 percent requirement to personal property used in connection with the real property. Property of an unrelated business cannot be included.

Proposed intrafamily lease will result in recapture.

IRS Letter Ruling 8307110 (Nov. 18, 1982)

For 16 years before her death, decedent cash leased ranchland to her half brother. For the last decade, actual ranching operations have been conducted by his sons. Under decedent's will, the property passes to her adult children. The children propose to continue the same lease arrangement.

The Service ruled that the nephews' ranching operations satisfied the predeath qualified use and material participation requirements because the nephews were members of decedent's family under IRC §2032A(e)(2).

Unfortunately, continuation of the arrangement will not satisfy the postdeath requirements. The qualified use requirement will not be satisfied because IRC §2032A(c)(1)(B) requires the qualified heir to use the property for the qualified use. "Qualified use is described in section 2032A(b)(2) as the use in the trade or business of farming. Under section 2032A(e)(4) the term farming includes ranching. Section 20.2032A-3(b) of the Estate Tax Regulations states that the term 'trade or business' under section 2032A applies only to an active business as distinguished from a passive investment activity. To qualify as an active trade or business, the qualified heir must be 'at risk' as to the ranching activity and have an equity interest in the ranch operation. A net cash lease is not considered sufficient to give the qualified heir an equity interest in the ranch due to the guarantee of the return. A lease based on a percentage of profits and losses, on the other hand, establishes an equity interest since the qualified heir is at risk as to the return on the lease." Accordingly, the proposed lease will not satisfy the qualified use requirement. Further, decedent's nephews are not members of the families of the qualified heirs. Therefore, their use of the property will not satisfy the material participation requirement.

Comment: There is often a need for the qualified heir to have a member of his family run the farm or other business. A surviving spouse retires (or has no business experience). Or several children inherit a farm, but only one of them wants to farm it. From the point of view of the persons involved, the ideal solution is often a net cash lease. Unfortunately, letter rulings have made it clear that the Service takes the view that such leases will trigger recapture.

In the Service's view, despite the fact that the statute expressly permits a member of the family to satisfy the material participation requirement, only the qualified heir can meet the qualified use requirement. The Service's position is based on a literal reading of IRC §2032A(c)(1)(B), which provides for recapture if "the qualified heir ceases to use...." This literal interpretation could be avoided by construing the phrase in light of the §2032A(c)(6) definition of cessation of qualified use. That section is evidence of a concern that the material participation requirement be met and that the property continue to be used for a qualifying use.

In any event, the Service has consistently taken the position that there will be recapture if the qualified heir net leases the property to the person satisfying the material participation requirement. With this ruling, the Service introduces the notion that a lease is permissible as long as the qualified heir remains "at risk." It is questionable whether Congress had any intent to force elderly widows to be "at-risk" with their children, but this result is a logical consequence of the Service's previous positions.

Because the financial burden of recapture can be devastating, counsel may wish to seek a letter ruling whenever an intrafamily lease is being considered.

IRC §§2032A, 2056: Special Use Valuation; Marital Deduction

Estate is entitled to a marital deduction for fair market value of qualified property even though property is specially valued.

IRS Letter Ruling 8314005 (Dec. 14, 1982)

On a district office request for reconsideration of an earlier Technical Advice Memorandum, the Service has affirmed that an estate is entitled to a full marital deduction even when the property is included in the gross estate at its special use value. The district had contended that the marital deduction should be reduced by the difference between the fair market value and the special use value.

For federal estate tax purposes, the special use value of the qualified property was its full value. Therefore, it could not be argued that the full value of the property was not included in the gross estate. Further, under Rev Proc 64-19, 1964-1 Cum Bull 682, property must be distributed at date of distribution values in order to qualify for the marital deduction. This requirement assures that the spouse receives property the fair market value of which is equal to the amount of the deduction allowed in decedent's estate. On the surviving spouse's death an amount equal to the amount of the deduction will be subject to tax in the survivor's estate, preserving the integrity of the marital deduction statutory scheme.

Comment: The probable result of this ruling will be to encourage the use of specially valued property to fund marital deduction bequests. Assume decedent's taxable estate is $2 million. The estate includes qualified property having a fair market value of $1 million and a special use value of $500,000. Assume also that the exemption equivalent amount is $275,000, and the will provides for funding a marital deduction bequest in an amount that will reduce federal estate tax liability to zero with the balance going to a bypass trust. Normally the bypass trust would be funded with property having a value approximating the exemption equivalent amount. However, electing special use reduces the taxable estate to $1.5 million. If the qualified property is valued at $1 million for purposes of the marital deduction it is only necessary to distribute an additional $225,000 to the marital deduction bequest in order to reduce estate tax liability to zero. This leaves approximately $725,000 for funding the bypass trust.

IRC §2041: Powers of Appointment

IRS denial of marital deduction in husband's estate on ground that wife was not given a general power of appointment did not estop IRS from later determining trust assets were part of wife's estate because she had general power of appointment.

Smith v U.S. (D Conn 1982) 557 F Supp 723

A husband and wife each created separate revocable inter vivos trusts. The husband died first. His trust provided that all income would be paid to his wife for life, and on her death any principal remaining in his trust would be transferred to the wife's trust. The wife had the power to amend or revoke her trust, in whole or in part. The Service denied a marital deduction of the husband's estate, determining the property interest passing to the wife under his revocable trust did not constitute a general power of appointment for federal estate tax purposes. This determination was not challenged by the husband's estate. On the wife's death, the Service determined that all assets of her trust, plus the amounts passing to it from her husband's trust, were includable in her estate because of her power to amend or revoke her trust.

The district court ruled that the surviving wife had a general power of appointment over her trust under local law. The estate contended that the IRS should be equitably estopped because it took inconsistent positions in the two estates. Relying on technical language in cases such as *Brantingham v U.S.* (7th Cir 1980) 631 F2d 542, the court ruled that the definitions of a general power of appointment for marital deduction purposes and for purposes of determining inclusion of a power of appointment in the gross estate are not necessarily the same. Therefore, the Service could not be said to have taken inconsistent positions. Nor could the estate support its contention that it had relied on the Service's position in the estate of the husband to conclude the Service would not assert the wife had a general power of appointment.

Comment: Although the conclusion is probably correct that there is no estoppel in this case, the part of the court's opinion concluding that different tests of a general power of appointment apply under IRC §§2041 and 2056 is, to say the least, confusing. The concept of a general power of appointment under §2041 includes the power to appoint to oneself, one's estate, one's creditors, or the creditors of one's estate. The power under §2056 is limited to the power to appoint to oneself or one's estate. However, nowhere was it con-

Statement
# of the
Chicago Bar Association
made to the
Subcommittee on Estate and Gift Taxation
# of the
Senate Finance Committee

in connection with hearings on various legislative proposals
regarding the repeal or revision of
the generation-skipping tax,
held on
June 27, 1983.

June 23, 1983

The Honorable Steven D. Symms
Chairman, Subcommitee on Estate
and Gift Taxation
Senate Finance Committee
Washington, D.C. 20510

Dear Mr. Chairman:

The Chicago Bar Association has reviewed the letter of Mr. John E. Chapoton of the Department of the Treasury, and the accompanying proposal to change the generation-skipping transfer tax. The Chicago Bar Association has previously gone on record favoring repeal of the current generation-skipping tax, including testimony before your subcommittee on two prior occasions.

Mr. Chapoton's proposal makes a compelling case for repeal. The existing tax has a scope so broad that it can apply to transactions of even a few hundred dollars; a complexity so vast that only a handful of specialists can understand the tax, yet the tax involves an area in which almost every attorney attempts to practice; the tax cannot possibly be administered or enforced effectively; and the wealthiest can avoid its provisions. Although Mr. Chapoton is quite correct that there is little or no experience with any tax imposed under Chapter 13, it is nevertheless the case that taxable distributions and taxable terminations have occurred in which Trustees cannot make full distributions or cannot terminate a trust for fear of the possibility of a generation-skipping transfer tax; because of Treasury's inability to produce any substantive regulations in final form, and its unwillingness to extend the date for filing returns and paying the tax beyond December 31, 1982, potential individual liability is a threat facing all those who administer or receive distributions from trusts or trust equivalents. Further, until repeal is enacted, this tax is still law and attorneys must take it into account in drafting estate planning documents for their clients. The generation-skipping transfer tax, in its current form, is a bad tax; and the need for tax in this area, if such a need exists, is no reason to retain a bad tax system.

The Chicago Bar Association stands willing to lend its counsel and cooperation with the Treasury in working on a new replacement tax if, indeed, such a tax is needed. It is the position of The Chicago Bar Association that no new proposal be enacted into law without full and complete deliberation by appropriate subcommittees of the Senate and House with participation by interested parties. The existing Chapter 13 was passed without an opportunity for critical and deliberate study of statutory language. What is needed is a full assessment of the nature of the problem, the various types of taxes that might help solve the problem, and finally a detailed examination of the provisions of any specific statutory language. Due to the admitted complexity of the tax and the necessity of very careful consideration of any new proposal, The Chicago Bar Association feels that repeal should be implemented immediately, without the simultaneous enactment of a replacement provision.

The problem of dealing with a statute that is very likely to be, but not guaranteed to be, repealed is insoluble. We pledge our cooperation in the evaluation of any new proposals. We urge the immediate and prompt repeal of Chapter 13.

Respectfully submitted,

THOMAS Z. HAYWARD, JR.
President

TZH/ss

CORPORATE FIDUCIARIES ASSOCIATION
of ILLINOIS

When responding, please
direct all replies to:

CHICAGO, ILLINOIS 60690

June 13, 1983

The Honorable Steven D. Symms
Senate Hart Building
Room 509
Washington, D.C. 20510

RE: Finance Subcommittee on Estate and Gift Taxation June 27, 1983 Hearing on Transfer Tax Issues; Department of the Treasury's Proposal Dated April 29, 1983 to Simplify and Improve the Generation-Skipping Transfer Tax

Dear Senator Symms:

The following are the comments of the Corporate Fiduciaries Association of Illinois regarding the proposal referred to above. The Corporate Fiduciaries Association of Illinois has been in existence for 67 years and represents 49 different banking and trust institutions that manage, in the aggregate, in excess of 70% of the institutional fiduciary funds held in Illinois.

In addition to its comments on Treasury's proposal, the Association wishes to reaffirm its position that immediate repeal of the tax on certain generation-skipping transfers, Chapter 13 of the Internal Revenue Code, is essential. The Association believes that the problems created by Chapter 13 are insolvable and that continuation of the tax both threatens this nation's voluntary compliance tax system and results in substantial and counterproductive expenditures of time and effort by the federal government, attorneys, corporate fiduciaries and a great many taxpayers. With these thoughts in mind, the Association in 1981 passed a resolution supporting repeal of Chapter 13. For the reasons given below, the Association continues to believe that repeal of Chapter 13 is the only feasible remedy.

PRESENT CHAPTER 13

The Case for Immediate Repeal

The proposal begins with a detailed indictment of present Chapter 13, Treasury conceding that "[t]here are a number of real problems with the present generation-skipping transfer tax". These problems include the scope, complexity, administration, effectiveness, fairness and lack of logical consistency of the present generation-skipping tax.

This indictment properly leads Treasury to conclude that present Chapter 13 should be repealed. Surprisingly, however, Treasury indicates that the present statute should not be repealed immediately, but only when and if Treasury's proposal becomes law. Treasury's proposal does not consist of technical patch-up but instead is a major overhaul of the existing system. While the Association agrees that an overhaul is required, it cannot agree that the existing tax should remain in force while the search for a solution is conducted.

Immediate repeal of present Chapter 13 would also remove estate planners from the purgatory of their present position. It is incumbent upon any attorney to plan and draft based upon existing law, yet any plan presently being drafted with a view toward present Chapter 13 almost certainly will have to be revised when present Chapter 13 is repealed. This is a needless waste of time, money and effort.

Admittedly, any plan drafted in the absence of a generation-skipping transfer tax would have to be reconsidered if a new tax is enacted, but the Association believes that fewer of those plans would have to be revised.

Taxpayers who have died with new wills or trusts signed after June 11, 1976 have created trusts often distorted by the existing tax. For example, these trusts often forgo individuals as trustees because of present Chapter 13 treatment of powers. Taxpayers who die while Treasury's proposal is being studied and modified will continue to use distorted provisions because the applicable law at death cannot be predicted. These trusts may last for many years, and the Association believes it is wrong for a law, which everyone now agrees ought to be repealed, to force such unwanted and undesirable estate plans.

In addition, although immediate repeal would result in a temporary absence of a generation-skipping tax, death is not a voluntary attempt to avoid transfer taxes. Generation-skipping trusts created by individuals who die during such a period would not be receiving a more fortuitous exclusion from taxation than Treasury itself advocates. Under Treasury's proposal, if present Chapter 13 remains in effect until enactment of a replacement, its retroactive repeal would not subject trusts created in the interim to new Chapter 13.

In summary, the Association believes it is wrong and illogical for Treasury to insist upon the continued existence of a tax condemned to death by Treasury itself. Chapter 13 should be repealed immediately.

If Not Repeal, Then Suspension of Chapter 13

If Congress accepts Treasury's position that present Chapter 13 should be repealed only when and if Treasury's proposal becomes law, then the Association urges Congress to suspend completely the application of present Chapter 13. Last year, a bill was introduced in Congress that would have suspended the application of Chapter 13 to all decedents dying before January 1, 1984. The Association supports similar legislation as an appropriate interim solution to the problems presented by present Chapter 13.

Treasury has stated its intentions to repeal retroactively the tax on certain generation-skipping transfers "so that no trust will ever be subject to the provisions of that tax." The continued applicability of Chapter 13 makes estate planning and trust administration more difficult and therefore more costly, both in terms of what an individual must pay for estate planning documents and trustee's fees and the amount of time that attorneys and trustees must spend to comprehend the tax. Despite this statute's existence for the past seven years, there are very few professionals who can claim mastery or a familiarity with the complex provisions that make up Chapter 13. This complexity translates into time and money, becoming in effect a deadweight burden on society.

TREASURY'S PROPOSAL

Introduction

On April 29, 1983 the Department of the Treasury published in prose, and not bill, form its "Proposal to Simplify and Improve the

Generation-Skipping Transfer Tax." A brief summary of the significant elements of Treasury's proposal is provided below, along with a comparison of Treasury's proposal and present Chapter 13.

The $1,000,000 Exemption

Each individual (designated a "transferor" under the proposal) will be permitted to make transfers aggregating $1,000,000 that will be exempt from the generation-skipping tax. The $1,000,000 exemption may be allocated against transfers made by the transferor during his or her lifetime or against transfers made at the time of the transferor's death. A transferor may apply his or her spouse's $1,000,000 exemption against transfers made by the transferor, so long as the spouse consents to such application. In addition, lifetime transfers that qualify for the gift tax exclusion [IRC §2503(b)] would be excluded for generation-skipping tax purposes.

The $250,000 grandchild exclusion in present Chapter 13 would be eliminated.

Application of the Tax

Subject to the exemptions discussed above, the proposal would apply a generation-skipping tax to property when all interests in the property are transferred to or held for the benefit of individuals at least two generations below that of the transferor without the payment of estate or gift tax in an intervening generation. Thus, the generation-skipping tax would apply immediately to outright transfers to any person two or more generations below the transferor and to any transfer in trust for the exclusive benefit of one or more such beneficiaries.

The proposal would tax direct transfers differently from generation-skipping transfers as presently defined, which will produce differing tax results depending on when (at the transferor's death or during his or her life) and how (directly or through an intervening trust or person) the transferee receives the property. It also means in the case of a direct transfer double taxation occurs. A direct transfer, whether in trust or outright, to a grandchild will incur either an estate tax and a generation-skipping tax or a gift tax and a generation-skipping tax.

Last, unlike present Chapter 13, the proposal would not provide an exclusion for income distributions from trusts. Instead, an income tax deduction would be provided for the generation-skipping tax imposed on such income distributions.

Computation and Payment of Tax

Generation-skipping transfers not covered by any available exemption would be taxed at a flat rate equal to 80 percent of the highest estate tax rate in effect at the time of the transfer. This would mean a generation-skipping tax rate of 40 percent in 1985 and thereafter.

The tax base for a generation-skipping transfer would not include the amount of any estate or gift tax payable with respect to such a transfer, but in the case of a direct transfer during the transferor's lifetime, the generation-skipping tax imposed on the transfer will be treated as an additional gift subject to the gift tax, even though the transferor is primarily liable for payment of the generation-skipping tax.

In the case of a direct transfer, whether by bequest upon death or gift, the generation-skipping tax base includes only the net amount received by the beneficiary. In all other cases, the generation-skipping tax base is equal to the full amount transferred, including the generation-skipping tax itself.

In cases where the generation-skipping tax is payable immediately upon the initial transfer, the transferor or his or her executor would be primarily liable for the tax. In all other cases, the transfer would come from a trust and the trustee would be primarily liable for payment of the tax.

Prior Transfers

The proposal states that it would deny the IRC §2013 credit for tax on prior transfers in the event the ultimate recipient of property is two or more generations below the original transferor. A special exception would permit the executor of the second decedent to elect to claim the credit if the executor also consented to have the two transfers of property treated together as a single generation-skipping transfer from the first decedent.

Effective Date

The tax imposed under the proposal would apply to all transfers from irrevocable trusts created on or after the date of enactment of the proposal and to all direct generation-skipping transfers made on or after that date. The proposal would not apply, however, to generation-skipping transfers (either outright or in trust) under wills or revocable trusts of decedents dying before the date that is one year from the date of enactment.

Comparison of Present and Proposed Chapter 13

In its proposal, Treasury lists six principal problems with present Chapter 13: scope, complexity, administration, effectiveness, fairness and lack of logical consistency. A careful analysis shows that these same problems remain largely unresolved under Treasury's proposal.

Scope -- Present Chapter 13 was criticized by Treasury as being overly broad for it affected virtually all trusts. The proposed tax would still affect a great many trusts, but additionally it would now cover a whole series of transactions, e.g., bequests made at death and gifts, not previously subject to the generation-skipping tax. Indeed, the scope of Chapter 13 has probably been widened, which when coupled to its still rather complex provisions is likely to result in substantial inadvertent noncompliance with the tax.

Although the $1,000,000 exemption is intended to restrict the generation-skipping tax "to the domain of the wealthiest families," the Association remembers that the $250,000 grandchild exclusion began as a $1,000,0000 proposal in 1976 and the $100,000 exclusion for qualified and individual retirement plan benefits began as a $500,000 proposal in 1981 after having once been unlimited in amount. Any reduction of the $1,000,000 figure would clearly widen the scope of the tax and raise a host of objections.

Complexity -- Treasury conceded that present Chapter 13 is extremely complex. But is the proposal any less complex? Treasury notes that present Chapter 13 "has no fewer than 13 defined terms which fit into an intricate pattern of rules and exceptions." Because the proposal is not in bill form, the extent of any undue complexity is difficult to judge. Suffice it to say that any legislation attempting to tax certain generation-skipping transfers must, in order to be inclusive, be complex. Treasury implies that under its proposal powers will not be deemed to be interests for Chapter 13 purposes and therefore can be ignored. This would eliminate a complex element of present Chapter 13. On the other hand, Treasury also indicates that there will be no need for a trust equivalent concept, and this seems hard to believe for if that is indeed true the Grand Canyon of loopholes awaits an eager taxpaying public.

The allocation features of the $1,000,000 exemption add complexity to the proposal and will need to be carefully refined. For example, if an individual upon death creates separate trusts valued at $1,000,000 for each of his three children and provides that each trust is to be distributed when the child for whom it benefits reaches the age of 30 years, must the exemption be applied at death by the individual's personal representative to one or more of the trusts or can it be saved and used some years later if one of the children dies before attaining the age of 30 years and his or her trust is distributed to his or her children? Also, trusts that are partially generation skipping (because of application of the exclusion) will cause administrative complexity for trustees.

In short, the complex elements probably required of proposed Chapter 13 have yet to surface.

Administration -- Treasury rightly pointed out that Chapter 13 is also unduly complex from an administrative standpoint. This was due in large part to the concept of a deemed transferor, which placed an incredible burden of record keeping and retrieval on the Internal Revenue Service. Further administrative difficulties were anticipated in keeping track of the $250,000 grandchild exclusion. Although neither the concept of a deemed transferor nor the grandchild exclusion is a part of Treasury's proposal, it would appear that extensive record keeping and retrieval are still required of the Internal Revenue Service. This is despite the fact that Treasury says such repeal "will eliminate the need for keeping records concerning the use of the $250,000 exclusion for transfers attributed to a deemed transferor." It would seem, however, that the new $1,000,000 exemption would substitute a similar record keeping obligation, particularly if, as discussed earlier, the exemption can be used after the transferor's death. The Internal Revenue Service will also need to develop some sort of system to cross check federal estate, gift and income tax returns to insure compliance with the tax.

The elimination of the income only exception will, in Treasury's view, close a tax loophole under Chapter 13; the cost, however, will be more complexity in estate administration. Under present Chapter 13, trustees knew that they did not have to deal with the generation-skipping tax for distributions as long as principal was not invaded. This no longer will be the case. The generation-skipping tax may have to be paid yearly on potentially small distributions. The deduction referred to in the proposal for income tax purposes does not prevent the same amount being subject to both income tax and generation-skipping tax if the IRC §691(c) pattern is followed. In effect, the only amount not subject to double tax is the amount of the generation-skipping tax. The rest of the distribution is taxed twice.

Effectiveness -- Treasury questioned the effectiveness of the generation-skipping tax because the wealthiest taxpayers were able to avoid the tax at various younger generation levels by layering their estates, i.e., passing large portions of their wealth to grandchildren (and even great grandchildren) through trusts in which no member of an intervening generation had a taxable interest or power. Additionally, Treasury noted its belief that many of the exceptions to taxation under Chapter 13 permitted well-advised taxpayers many opportunities to avoid the tax. All of this, Treasury correctly points out, led to taxpayers adopting more complex estate plans deviating further from each taxpayer's natural dispositive preferences.

Here, too, the proposal does little to correct the problem, in part because of the flat rate tax. A one time flat rate tax will encourage the use of the very type of trust considered to be the abuse Chapter 13 was intended to stop. Long-time multi-generational trusts will offer an obvious tax advantage over outright transfers. The very wealthy will receive the benefit of a tax which is only 80% of the maximum tax rate. In addition, the very wealthy can afford to tie-up the property for many generations and thus take advantage of the single generation-skipping tax that will be incurred instead of a tax once each generation. It is ironic that the abusive trust that for forty years has been the motivating factor behind some kind of generation-skipping tax will again be useful. The burden of transfer taxes, however, will be imposed more frequently on moderate sized estates that cannot afford to tie-up trust property for multiple generations. In this regard, Treasury's proposals will be ineffective to remedy what was once the perceived abuse.

Fairness -- This area is closely related to the issue of effectiveness, as Treasury believed that the complexity and ineffectiveness of present Chapter 13 was a source of unfairness. Again, the rule that only one generation-skipping tax will be imposed upon a trust is a tremendous incentive to create generation-skipping trusts, particularly for the very wealthy. Also, the flat tax rate of 80% of the highest transfer tax rate will operate as a penalty for moderate sized generation-skipping trusts and as a significant advantage for larger generation-skipping trusts.

Treasury's proposal also introduces a new element of unfairness. The legislative history behind present Chapter 13 condoned the many legitimate nontax purposes for establishing trusts so long as the tax laws were otherwise neutral and no tax advantage accrued to a trust. Treasury's proposal seemingly reverses that position, imposing obvious disadvantages for trusts when compared with an outright transfer to a younger generation. For example, the annual exclusion of $10,000 per donee, IRC §2503(b), is not applicable for transfers from a generation-skipping trust. The Association sees no reason why the mere existence of a trust should suddenly mean unfavorable tax status.

The legislative history of Chapter 13 indicates that the original purpose of the generation-skipping tax was to treat property passing from one generation to successive generations in trust the same for estate tax purposes as property transferred outright from one generation to a successive generation. In responding to criticism of present Chapter 13, Treasury's proposals have introduced an entirely new concept. The proposal would tax property because a member of an intervening generation did not receive an interest in the property; present Chapter 13, however, levies no tax unless there is (or was) an interest in the property in a member of an intervening generation. Taxing direct transfers to generations two or more levels younger than the grantor clearly was not a goal of present Chapter 13. Chapter 13 was introduced to treat trusts the same as outright transfers. The proposal to tax direct transfers in effect will treat direct transfers like generation-skipping trusts, a major departure from prior tax policy. The Association believes that such a change should not be undertaken lightly or quickly. In particular, the effect of taxing direct transfers should be studied where the parent of the transferee who is the child of the transferor is deceased. Imposition of a generation-skipping tax in this instance seems inequitable.

Lack of Logical Consistency -- Treasury found fault with present Chapter 13 because it "is not based on any logically consistent view of the Federal transfer tax system." Logic, in Treasury's view, is to impose a tax at least once per generation, and in order to accomplish this Treasury is forced to levy two transfer taxes on each direct transfer.

The Association, however, views a logical transfer tax system as one that imposes one federal transfer tax on each taxable transfer. The Association considers it illogical to subject direct transfers to two different types of federal transfer taxes simultaneously. The legislative history behind present Chapter 13 makes it clear that Congress believed tax abuses resulted from the creation of generation-skipping trusts. It was this sort of property that got beyond the grasp of the tax collector; direct transfers remained fully subject to either the estate or gift tax. In its proposal, Treasury offers no reason (other than "logical consistency") or evidence why it is suddenly abusive for transfers to be made directly to individuals two or more generations below the generation of the transferor. This rule, in effect, means that a transfer from an individual to his or her grandchild, made in many cases because the parent of the grandchild is deceased, will be taxed at a substantially higher rate than a transfer from an individual to his or her child. If this is logical, it is also harsh and inequitable.

CONCLUSION

Treasury's proposal addresses some of the problems with present Chapter 13. The above comments, however, demonstrate that further problems have been created and some difficult policy decisions will need to be made before a new tax can be enacted. These policy decisions should not be taken lightly or made hurriedly. In the interim, it is fundamentally unfair to retain the existing generation-skipping tax law in light of its problems. Treasury concedes and the Association agrees that the existing tax is unworkable and unfair and should be repealed. Considering the difficult policy decisions to be made, it is not clear whether Treasury's proposals will eventually be enacted into law. The arrangement of one's affairs to minimize taxes is a time-honored and legitimate tradition in our tax system. If the present generation-skipping tax is not immediately repealed, taxpayers have no choice but to plan their testamentary affairs in light of the tax. Unfortunately, taxpayers will continue to die despite any promise to correct the existing generation-skipping tax. Those taxpayers will have documents that go into effect and are irrevocable which have been drafted in light of the existing law. Death is not an elective transaction which can be postponed until Treasury's proposal can be acted upon by Congress. The lack of priority given to this area is evident. Nearly seven years of uncertainty have existed for taxpayers. It is time that taxpayers know what law applies. The existing tax should be retroactively repealed at once.

Respectfully submitted,

Corporate Fiduciaries
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June 28, 1983

Subcommittee on Estate and Gift Taxation
U. S. Senate Committee on Finance
Room SD-221
Dirksen Senate Office Building
Washington, D. C. 20510

Re: Hearing to Discuss Estate
Tax Issues
June 27, 1983

Gentlemen:

The future of the vast majority of the agricultural enterprises, especially the family farms, and small businesses in the U. S. is closely allied to estate tax provisions. From both a social and an economic point of view, it is critical that such businesses continue as family operations. Although unwritten, this philosophically and practically is a national policy.

Family farms of necessity are highly capitalized with a value of a million dollars not unusual. Many, also of necessity, are heavily leveraged finacially. For such operations to continue, preferably within the family, forced sales to meet estate tax burdens would be devastating. This has been true in the past. Clearly, it will be true to an even greater extent in the future.

To renege on the interim relief which has been provided through 1987 by the Economic Recovery Tax Act of 1981 would exacerbate the problem for years to come. This must not be allowed to happen! We are confident that your Subcommittee will not permit it to happen.

On this critical economic issue, the long-standing policy of the HOLSTEIN ASSOCIATION, updated only to account for the 1981 legislation, is as follows:

> "That family retention and operation of farms and small businesses is a highly desirable social-economic goal. That complete elimination of estate taxes would be a major contributor to reaching that goal. Therefore, the upward ratcheting of estate tax exemptions under present law must continue as scheduled."

Within the context of the above policy as you consider estate tax issues as a part of the larger matter of the July 1 implementation of the provisions of the 1981 tax legislation, I urge you in the strongest possible manner to adopt Senate Resolution 126 which "expresses the sense of the Senate that the changes in the Federal estate tax laws made by the Economic Recovery Tax Act of 1981 should not be modified."

Such action must be considered as the absolute minimum to stay the course of the well-conceived provisions of the 1981 Act as it relates to estate taxes.

At some opportune time in the future, it would be appropriate for your committee to consider favorably the provisions of S-1250 to repeal the estate and gift taxes.

On authorization of the Board of Directors of Holstein-Friesian Association of America, I am privileged to make this positive statement of position on behalf of the 43,600 dairymen-members of the Association who are located in 49 of our 50 states.

Your favorable consideration of this recommendation is appreciated.

Sincerely,

Robert H Rumler

Robert H. Rumler
Chairman Emeritus

RHR/brg

STATEMENT OF THE
INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA
TO THE SUBCOMMITTEE
ON ESTATE AND GIFT TAXATION
OF THE
SENATE COMMITTEE ON FINANCE

The Independent Petroleum Association of America is a national organization of some 7,000 independent oil and natural gas producers in every producing area of the United States. IPAA, together with the twenty-nine unaffiliated oil and gas associations listed on the cover page, represent virtually all independent producers and thousands of royalty owners in the United States. We are grateful for the opportunity to provide comments with respect to S. 1251 concerning an area which has broad application and will personally affect many of our members.

In general, estate taxes must be paid within nine months after death. Section 6166, however, contains an important exception where more than thirty-five percent of the adjusted gross estate consists of assets of a closely held business. Under this provision, a qualifying estate may elect to pay the portion of the tax attributable to the closely held business in installments over a period of time not to exceed fourteen years.

These provisions were designed to aid and encourage small businesses, by preventing their break-up, in order to pay death taxes and to prevent their consolidation into larger businesses. The installment payment provisions contained in Section 6166 provide that all proprietorships owned by the decedent at the time of his death, qualify as an interest in closely held business. In addition, an interest in a closely held business includes interests in partnerships and in corporations if a specified threshold level of ownership is satisfied. An interest in these enterprises is included as a closely held business, if the decedent had a capital interest in the partnership of 20% or greater, or owned 20% or more of the voting stock of a corporation; or the partnership or corporation has 15 or fewer partners or shareholders. Where the estate includes more than one closely held business, the separate businesses can be combined only if the decedent owned a capital interest of 20% or more in each business.

The provisions for installment payment of the estate tax have been very valuable in preventing the forced sale of family owned businesses. However, clarification of the application of the provisions to the oil and gas industry is required to alleviate unintended and inequitable treatment of estates holding oil and gas interests.

Because of the high risk involved in oil and gas exploration, the large investments required and the difficulty in obtaining large blocks of leaseholds, producers commonly arrange to conduct exploration and development activities as a joint undertaking. The rights and responsibilities of the parties will be set forth in a contract, usually referred to as a "joint operating agreement". This operating agreement will normally assign to one of the parties primary responsibility for management and operation of the property. This person, "the operator", will supervise operations approved by the other parties, pay bills, maintain records and in turn bill the other owners for their share of the costs. The proceeds from the sale of the oil or gas produced are normally paid directly to the interest owners by the purchasers. Operations on most oil and gas properties are conducted under some variation of this format.

Although the participants under these agreements are conducting joint operations, the parties seldom wish to become true partners. These agreements typically state the express desire that the enterprise not be viewed as a partnership. The agreements are not recognized as partnerships under common law, the parties do not have joint liability, and most of the indications of the existence of a partnership are absent.

The definition of a partnership under the Internal Revenue Code (see Section 761 and 7701) is, however, broad enough to encompass most, if not all of the forms of joint operations of property in common use in the oil and gas industry, including operations under a joint operating agreement, as described above. When the Internal Revenue Code was adopted in 1954, it was recognized that the inclusion of such joint operations under the partnership provisions would not be practical or equitable. Section 761 (a)(2), therefore, provided that an organization formed for the joint production, extraction, or use of property, but not for the purpose of selling services; or property produced or extracted could elect to be excluded from the provisions of the Internal Revenue Code dealing with partnerships (Subchapter K). Where an election is made under Section 761, the provisions of the Code affecting partnerships do not apply, and the co-owners report their respective shares or the items of income, deductions and credits of the organization on their respective tax returns, as if they held the property directly. This election, however, applies only to the provisions of Subchapter K, and for all other purposes of the Code, the organization is to be treated as a partnership.

In determining how these provisions should apply to oil and gas ventures, taxpayers have for years relied upon the Revenue Service position stated in Revenue Ruling 61-55, 1961-1C.B.713. In Revenue Ruling 61-55, the Revenue Service stated that where the decedent had been engaged in "commercial activites of owning, operating, exploring and developing mineral properties as a sole proprietor", working interests in oil and gas properties qualified as part of a closely held business under Section 6166. The mere ownership of oil and gas royalty interests, however, was held not to qualify. The ruling makes no mention of the provisions of Section 761 or the rules under Section 6166 for combining interests in separate businesses. The ruling implies that the decedent's oil and gas activities are to be viewed as a single integrated proprietorship, regardless of the number of joint operating agreements through which the operations were conducted. This interpretation was accepted by both taxpayers and the Revenue Service for nearly two decades. The Revenue Service has recently reversed this position in some cases and is asserting that under Section 761 each interest in a mineral property which is jointly owned constitutes a separate partnership interest. The partnership interest is subject to the specific provision of Section 6166 and the separate interests can be combined only if the decedent owned 20% or more of each property.

This interpretation, which is directly contrary to accepted practice, would virtually eliminate the availability of the installment payment provisions for oil and gas producers conducting their operations as a proprietorship. Regardless of the technical merit of the interpretation currently being advanced by the Revenue Service, this treatment was never intended by Congress and should be clarified. This bill, S. 1251, accomplishes this. Since the provisions for installment payment were enacted in 1958, individuals holding oil and gas working interests have considered themselves to be actively engaged in a trade or business for purposes of Section 6166. The estates of these producers were routinely granted the installment payments where the oil and gas properties constituted a sufficiently large closely held business. Neither the producer nor the government felt the provisions of Section 761 were intended to effect the treatment of co-owned properties. During the nearly twenty-five years the installment payment provisions have existed, there are only two reported instances where Section 761 has been held by the government to limit the application of Section 6166. The amendments being made by S. 1251, therefore, do not serve to expand the availability of the Section 6166, but are merely a clarification and reaffirmation of the existing treatment.

In addition, the bill will alleviate inequitable treatment accorded to certain estates holding mineral royalty interests. It is common in the oil and gas industry for certain persons, such as land men, geologists and lease brokers to acquire nonoperating mineral interests through the performance of their services. Such an arrangement allows the owner of the operating interest to invest a smaller amount of cash in the property and provides the party performing the services a stake in the success or failure of venture. In such a situation, royalty interests acquired in this manner are a fundamental income producing factor in the business. Under the current bill, the definition of an interest in a closely held business would be amended to include an overriding royalty interest, a net profits interest or any other nonoperating interest in mineral property which had been acquired by the decedent in exchange for services he had rendered in determining the location, extent of the minerals, or in acquiring or leasing the minerals. This amendment would result in a more uniform application of the installment payment provisions and should be given careful consideration.

Independent Petroleum Association of America
July, 1983

WRITTEN TESTIMONY OF
NORMAN B. TURE
CHAIRMAN, INSTITUTE FOR RESEARCH
ON THE ECONOMICS OF TAXATION
BEFORE THE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
SENATE COMMITTEE ON FINANCE

JUNE 27, 1983

HEARING ON ESTATE TAX ISSUES

As part of the Economic Recovery Tax Act of 1981 (ERTA), Congress overhauled the laws governing Federal estate and gift taxes. A major theme of these reforms, which were needed and for which Congress is to be commended, was that the bracket creep that had occurred because of the interaction between inflation and graduated tax rates should be corrected. A subsidiary motive was to lessen the inefficiency resulting from the lost saving and misguided investments induced by the high marginal rates of estate and gift taxes. The question that will be asked here is whether the reforms accomplished these objectives. The answer is that although the changes did bring improvements, they were far from totally successful.

Outwardly, the reforms achieved their primary goal of redirecting estate and gift taxes toward the wealthiest members of society. Doubts about this emerge, however, as soon as one realizes that taxes may be shifted from their apparent payees to others in society. Regarding the inefficiencies, which occur because the taxes distort relative prices, the changes eased but did not eliminate the problem. These issues will now be discussed in more detail.

The major goal of the portion of ERTA covering estate and gift taxes was to protect the middle class from the inconvenience and monetary cost of these taxes. To accomplish this goal, the unified credit is being raised over a transition period lasting until 1987 from $47,000 (equivalent to a $175,000 exemption) to $192,800 (equivalent to a $600,000 exemption). The annual per person gift tax exclusion has already been increased from $3,000 to $10,000.

Prior to these changes, bracket creep had exposed millions of small businessmen, farmers, homeowners, and others in the middle class to wealth taxes that were supposedly restricted to the super rich. Giving one's child an automobile or a year's college education could easily exceed the old annual gift tax exemption. Including a median valued California home in one's estate used up almost half of the unified credit. Estate taxes were forcing an increasing number of farms and small businesses to be sold, often at distress prices because of the time limit on paying the taxes.

Another major change, motivated by a different issue of equity, concerns the marital deduction. Under the old law, either $250,000 or one-half of the taxable estate, whichever was greater, could be transferred tax-free between spouses. The 1981 reform modified this to an unlimited transfer, striking down what some critics had dubbed the "widows' tax." One argument in favor of this change is that a married couple is often treated like a single unit as, for example, by the individual income tax. Regarding asset transfers between them as though they were taxable events is thus an anomoly. A more fundamental argument involves the primary intent of estate and gift taxes. If they are defended as limitations on intergenerational transfers (rather than the more cynical theory they they are just another governmental technique for grabbing a few tax dollars here and a few there), it is clear that transfers between spouses did not belong in this tax base in the first place.

Although these equity problems were serious enough to merit attention in their own right, estate and gift taxes by their very nature create a distortion whose economic damage may be even greater. As levies on the interpersonal (usually intergenerational) transfer of accumulated savings, they raise the cost of saving relative to the cost of consumption. This, in turn, discourages saving and impairs capital formation. The long run consequence is slower growth and a smaller supply of goods and services for everyone, not just for those who pay estate and gift taxes directly.

Only in the last several years has the magnitude of this problem come to be appreciated. Until recently, the efficiency loss due to estate and gift taxes was held to be small because of two perceptions that have now been cast into doubt. One of the beliefs concerns why people save. One economic theory postulates that people save mainly to smooth out their consumption patterns over their lives: there are periods when earnings are higher than others, but it is desirable to maintain some basic standard of living during all the years of one's life. A common example is that people save to fund their retirement and other periods of unemployment. It is clear that saving for this purpose is an important motive, but it was previously believed that it was the only purpose; the decision to leave bequests was relatively unimportant; passing wealth on to others was an after-thought. Pursuing this logic, the drop in saving due to taxing wealth transfers would not have a significant effect on saving because saving for the purpose of making a bequest was thought to be relatively insignificant.

Recent research, however, has turned this comforting notion on its head. A study conducted by Laurence J. Kotlikoff and Lawrence Summers of the National Bureau of Economic Research and the Massachusetts Institute of

Technology has concluded that the great majority of accumulated wealth in the United States is transferred from generation to generation. The vast majority of savings are eventually conveyed to others, not used up during one's lifetime. Thus this form of saving is terribly important. Anything that discourages it is of great concern.

Having determined that bequests are a significant proportion of saving, one must consider how taxes affect saving behavior. Every tax has the attribute of changing the relative costs facing actors in the economy. What estate and gift taxes do is to increase the costs of providing an income stream for a future generation, relative to consuming now. A reassuring (to the proponents of transfer taxes) but erroneous belief was that saving was relatively insensitive to its after-tax rate of return; that is, raising the tax on income from saving would have little effect on the amounts that people save. In this view, although the estate and gift tax might reduce the wealth passed on within the private sector, the resulting decline in saving would be small. This sanguine view is being challenged, however, by increasing evidence that saving is quite responsive to its cost. For this reason, it is increasingly recognized that additional taxes on income that is saved or on the income from saving can reduce saving significantly.

It may be helpful to illustrate with an example of how estate and gift taxes raise the cost of saving. As stated above, one of the primary motives for saving is to leave a bequest to one's heirs. Suppose an individual wants to leave a bequest of $100 to his heirs. In a simple world, absent estate and gift taxes, the cost of transferring $100 is exactly $100; that is, he must give up $100 of consumption in order to leave the bequest.

Now suppose an estate tax of 25 percent is levied. In order for the person to leave an after-tax bequest of $100, he would have to accumulate $133.33. The cost of leaving the desired wealth to his heirs has increased—he must now forego $133 of present consumption to leave the desired amount. Economic theory tells us that, given this increased cost, he will be discouraged and as a result will save less and bequeath less than $100.

Of course, in the real world the situation is even more serious. Saving and the income it produces are taxed many times. Begin with an individual who earns income. That income is taxed. Assuming the individual saves some of his after-tax income, the income from his saving is taxed again as interest or dividends or capital gains (if realized in his lifetime). If the purpose of the saving was to leave some wealth to his heirs, this saving is taxed yet again under the provisions of estate and gift taxes. Because marginal tax rates on estates rise to extremely high levels, up to 60 percent in 1983 on transfers exceeding $3.5 million, one should not be surprised if vigorous efforts are undertaken to avoid the tax and if saving for bequests falls. The unfortunate result is a drop in the rate at which society saves and accumulates wealth.

Besides inhibiting saving, estate and gift taxes contribute to inefficiency by pushing saving along less desirable avenues. The high marginal rates reached by these taxes mean that even grossly inefficient investments of little use to society may be able to pay for themselves if they can shelter some of the transfer from taxes. That is, investments of little value to the economy, which consequently yield unattractively low market rates of return, may nevertheless become attractive because of the subsidy that the tax system confers on them. This misallocation of saving, coming on top of the previously discussed overall reduction in saving, delivers a second blow to the nation's efforts to increase productivity and output and to better the living standard of the average American.

Considering how many different U.S. taxes punish saving relative to consumption (e.g., individual income tax, corporate income tax, estate and gift taxes), it is hardly surprising that the United States has the lowest saving rate in the industrialized world. Given the present concern regarding the adequacy of saving and investment, this is surely a perverse tax policy.

By 1981, the problem had become acute because estate and gift taxes began at such low thresholds and because they were set at such high marginal rates. The initial rate, after the unified credit had been exhausted, was 32 percent. On estates exceeding $5 million, the marginal tax rate rose to 70 percent. No wonder estate planning was such a growth industry for lawyers and accountants! For a person with a large estate, a tax avoidance plan would pay for itself as long as it cost less then $.70 for each $1 of inheritance that it shielded. Returning to the saving-consumption choice, consider an individual with a $200,000 taxable estate. The tax angle made it worthwhile to consume unless $1 of consumption brought the individual less enjoyment than $.68 passed along to his heirs.

The 1981 reform reduced enormously the adverse impact of estate and gift taxes on saving. At the bottom of the scale, it exempted most estates entirely. At the top end of the scale, it will gradually lower the highest marginal rate to 50 percent by 1985. This still penalizes intergenerational saving, but less powerfully than before.

The penalty on saving has not been reduced for everyone, however. Marginal tax rates remain unchanged for estates between $600,000 and $2,500,000. These rates range from 37 to 49 percent.

The message here is that although estate and gift taxes are less of an impediment to investment and growth than they were prior to ERTA, their distortionary effect has not disappeared. Unless these taxes are eliminated, they will continue to raise the cost of saving relative to consumption. An unavoidable trade-off exists between estate and gift taxes and an efficient saving-consumption choice.

While not disparaging the improvements contained in ERTA, it should be recognized that both the technical design of Federal estate and gift taxes and their very nature as levies on one of the most important categories of saving impair their ability to accomplish their alleged equity objectives. Although legislative changes could repair the first defect, they could not remedy the second.

The history of modern estate and gift taxes sheds light on their goals. While the need to raise revenues is the cornerstone of any tax, estate tax advocates always put forth additional justifications. One of the earliest calls for an estate tax on grounds other than mere revenue raising came from the trust busting rhetoric of President Roosevelt in 1906. President Roosevelt called for "a progressive tax on all fortunes beyond a certain amount...a tax so formed as to put it out of the power of the owner to hand on more than a certain amount to any one individual." Even though Roosevelt paid lip service to the tax as a revenue raiser, in a later reference to the tax he said, "As an incident to its function of revenue raising, such a tax would help provide a measurable equality of opportunity for the people of the generations growing to manhood."

Although the United States experimented with a number of death taxes before this century, the modern estate tax must trace its origin to the

Revenue Act of 1916, which introduced the estate tax to America. The act substantially furthered the concept of "ability to pay" as a basic tenant of U.S. tax philosophy. While the stated purpose of the legislation was to fund "the extraordinary increase in the appropriations for the Army and Navy and the fortification of our country," the House Ways and Means Committee report accompanying the act states:

> No civilized nation collects so large a part of its revenues through consumption taxes as does the United States, and it is conceded by all that such taxes bear most heavily upon those least able to pay them.

The report goes on to state:

> ... our revenue system should be more evenly balanced and a larger portion of our necessary revenues collected from the income and inheritances of those deriving the most benefit and protection from the government [emphasis added].

Based on these arguments, one would expect the present Federal levy to be an inheritance tax. It is not. Instead it is a tax on transfers. Accordingly, the estate, not the heir, is the taxpayer. With an inheritance tax, attention is focused on how much wealth passes to each beneficiary. Bequeathing a large amount to a single heir incurs a greater tax liability than splitting the same amount among many recipients. In contrast, an estate tax looks at the total amount being transferred, not how widely it is spread.

Notice a trade-off here. An inheritance tax concentrates on limiting the accumulation of wealth over generations but, by offering lower tax rates if bequests are split, may collect less revenues than an estate tax would. If this trade-off was the hidden reason for choosing an estate tax instead of an inheritance tax, the Federal government made a poor selection. The revenue contribution of the tax is simply not large enough to justify its basic design. In 1980, estate and gift taxes contributed only 1.2 percent of Federal budget receipts.

Even a radical legislative overhaul, however, could not remove a fundamental contradiction between the alleged goals of estate and gift taxes and their actual effects. The contradiction is resistant to technical tinkering because it stems from the very nature of these taxes. As levies on saving, they create economic distortions that shift the tax burden from the supposed payees, the very rich, to individuals in all income classes, including the very poorest.

To understand how these taxes are shifted, begin by remembering th[illegible] they boost the cost of saving relative to consumption. The resulting decline in the saving pool means that there is a smaller addition to the stock of capital. With relatively less capital at their disposal, workers are relatively less productive and receive commensurately lower real wage rates. It is clear that estate and gift taxes are paid, directly or indirectly, by people at all levels of income.

To summarize, the overhaul of estate and gift taxes accomplished through ERTA was an excellent step. It was more successful, though, at addressing some of the equity problems arising from these taxes than in correcting their inefficiencies. The danger exists, nevertheless, that some observers may believe the reforms went too far and want to roll them back. On the contrary, the case made here is that the 1981 reforms may not have gone far enough.

Statement of
The National Association of Wheat Growers
before the
Subcommittee on Estate and Gift Taxation
of the
Committee on Finance
United States Senate
June 27, 1983

Mr. Chairman and Members of the Subcommittee:

The National Association of Wheat Growers appreciates this opportunity to comment on estate tax issues.

Ultimately, complete repeal of the estate tax is a necessary reform in encouraging aggressive entrepreneurship in the nation's small business establishments and family farms. Anticipation of the inevitable loss to the heir of a significant portion of an inherited business simply to pay estate taxes serves as a disincentive to investing in and building a business or family farm. Efficient farming can only be achieved through full utilization of economies of scale, and a farm must remain a viable unit at the time of death of the owner/operator when it is passed to the heir. Typically, farmers today are very highly leveraged, with relatively tight liquid assets. In order to meet a very large estate tax debt, therefore, it is not uncommon for the new operator to be forced into liquidating a portion of his equipment, land, or other productive asset, since estate taxes become due in a very short period of time. The sale, in turn, handicaps the farm operation, and can result in the creation of an inefficient, non-viable farm unit which must ultimately be liquidated in its entirety or drastically reorganized in order to remain operational.

I question whether our nation's estate tax system should be allowed to force structural changes in family farm units and other individually held businesses. Establishment of many types of businesses and farms is almost impossible in today's economy without a great deal of financial backing or without having inherited the business. It is commonly agreed that the system of individually owned and operated farms is the most efficient possible. We therefore argue that tax laws must be designed so that this system can be preserved, rather than destroyed, and investment in increased productivity encouraged, rather than prevented.

Estate taxation essentially works to destroy this system. For this reason, the wheat industry, working with other small business and similar interests, worked very hard to achieve increases in exemption levels and decreases in tax rates over a five-year period in the 1981 Economic Recovery Tax Act. We strongly oppose any changes to these scheduled increases, which were the first to be implemented in several years, in spite of rampant inflation during this period. Between 1971 and 1982, for example, the value of the nation's farmland nearly quadrupled in value, in response to these inflationary trends.

Even the scheduled exemption increases in ERTA do not result in realistic tax treatment of farm estates. The land alone on an average-sized continuous crop wheat farm of 1,000 acres would typically be valued at $1 million. The value of the farm equipment would easily reach half that level. Buildings, stored grain, and other assets could average $250,000 with a total estate value, using this example, of $1.75 million. The tax on the estate would be approximately $589,000, even after the current credit is applied. Assuming average yields and current prices, the farmer would have to turn over to the government the equivalent of nearly five years' production on his farm. The more likely alternative would be to sell a portion of his assets in order to meet this tax debt. Meanwhile, payments would in all likelihood be due the bank on the very assets for which the farmer is being taxed by the government. In this situation, the producer would have a very difficult time remaining solvent without selling some portion of his farming operation.

Short of repeal, the NAWG proposes reforms in several areas of the estate tax code. We urge the subcommittee to bear in mind the importance of continuing scheduled increases in exemption levels for estate taxes beyond those scheduled through 1987. The exemption level in 1987 will reach $600,000. Meanwhile, assuming that inflation will continue at a steady, if modest pace, farmland values should rise, and will therefore result in an even higher valuation for extate tax purposes. The increased value of the estate to be taxed could easily make up for any tax breaks provided in the current law.

Another strategy to be considered in making the estate tax more equitable, and, ultimately, phased-out, is reducing the tax rates by scheduled amounts. The highest rate in 1987 will be 50 percent, with reductions for estates at all levels of valuations. It is extremely important that rate reductions scheduled through 1987 be enacted, and that similar reductions be planned beyond 1987.

Under present law, only real property that passes to qualified heirs is eligible for current use valuation. The term "qualified heir" means a member of the decedent's family, including the spouse, parents, brothers and sisters, children, stepchildren, and spouses and lineal descendants of those individuals. It does not include lineal descendants of the decedent's grandparents, however, as previous law once did. This inclusion allowed a cousin of the decedent, for example, to operate the farm. The NAWG believes that "qualified heir" should be broadened to include lineal descendants of the decedent's grandparents, since this would more accurately reflect the realities of family farm operations.

The NAWG also encourages the Congress to consider the need for repeal of the cap on special use valuation benefits, which is set at $750,000 for 1983. Short of repeal, Congress should give strong consideration to phased-in repeal at the earliest opportunity.

The NAWG supports passage of the repeal of the generation-skipping transfer tax. Administration of this tax collection is extremely complex, and creates very little income for the Treasury. Just as regular estate taxes create a disincentive for building small businesses such as family farms, the generation-skipping transfer tax is an inequitable hindrance to rationalization of farm operations.

NATIONAL
FARMERS
UNION

STATEMENT OF

RUTH E. KOBELL
LEGISLATIVE ASSISTANT
NATIONAL FARMERS UNION

PRESENTED TO

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
COMMITTEE ON FINANCE
UNITED STATES SENATE

REGARDING

ESTATE TAX ISSUES

JUNE 27, 1983

Dear Mr. Chairman:

I am Ruth E. Kobell, Legislative Assistant, National Farmers Union, 600 Maryland Avenue, S.W., Washington, D.C. We represent 300,000 farm families in the heartland of America from the Pacific Northwest to the rich farmlands of Pennsylvania, from the Canadian border to the varied agricultural pursuits in Texas.

The family farm is the keystone of our policy. We believe family agriculture is the base of a strong national society.

We remain wholly dedicated to the strengthening of the family farm system and resolutely oppose an industrialized type of corporate farming or domination of farm ownership and operation by off-farm or alien interests.

Our American system of farming is the most viable system of food and fiber production. It is in the best long-term interest of the nation, and it provides the most widespread benefits to all in our society. Yet its survival and continuance is not assured.

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Farm families have been on a roller coaster of escalating farm operating costs and widely varying commodity prices for the last decade. High interest rates have escalated the cost of farm operations for our commercial family farmers who are required to borrow operating capital as well as money to buy the farm and equipment. The steady rise in land values over the last decade provided the collateral for farmers to go to the bank to borrow for another year's crop, but depressed commodity prices did not provide the income for repayment. The recent leveling off and decrease of farmland values have thrown many farmers into an extremely difficult credit position. Without the escalated land value to continue their borrowing, they have only 57% of parity farm income to make either repayment or refinancing more difficult.

During the period of escalating land values, many farms increased in worth so that efforts to continue to transfer family farms within the immediate family demanded major attention to estate taxes. These concerns were addressed in the 1981 Tax Act to provide some relief in the settlement of estates.

Delegates to the National Farmers Union Convention in San Diego last March adopted the following statement regarding the issue of estate and gift tax policy:

> "There is deep concern for the preservation of the family-sized farm in this nation, and a general agreement that the federal estate tax plays an important role in the future of the family farm.
>
> "Presently, only estates of more than $175,000 incur federal estate taxes. The 1981 Tax Act increased the amount of the

unified estate and gift tax credit from $47,000 to $192,800 over a 5-year period, providing an exemption for estates valued up to $600,000 in 1986 and thereafter. The annual gift tax exclusion was raised from $3,000 to $10,000 per recipient. In addition, no estate left to a surviving spouse will be taxed. The rate at which an estate will be taxed will drop from the present 70 percent by annual 5-percent decreases, to 50 percent in 1985 and thereafter.

"The substitution of an inheritance tax for estate tax should be studied as a more acceptable alternative as the inheritance tax is paid by those inheriting the property and wealth, thereby spreading the tax liability, rather than concentrated against the estate.

"A land ownership transfer policy should be established which encourages a retiring farmer to transfer his farm prior to death to a beginning farmer, and efforts must be made to find private or public funds available for such programs.

"Due to recent significant changes in estate tax law, we urge our members to study the law and its regulations and update their estate tax planning to reflect these changes."

Several years ago, Farmers Union delegates asked their National Farmers Union Life Insurance Company to provide advisory assistance to patron members in outlining some of the options for estate planning. The company has provided a specially trained staff to work on a confidential basis with our members to assist them in this area.

I asked Mr. Kip Keehner, Vice President of the Life Marketing for National Farmers Union Life Insurance Company, to share some of the recommendations of his staff in this area. Since they represent perhaps the largest single source of agribusiness estate planning in the United States, I felt that they were familiar with many of the problems of passing along the family farm.

Mr. Keehner said they felt that estate tax legislation should realize and permit transfers prior to death under special prepayment provisions. Such a prepayment alternative would, in their opinion, be a resolution to many of the cost, administrative, legal, tax collection and societal problems associated with farming, ranching and family. Following is a statement from Mr. Keehner outlining recommendations which I commend to your subcommittee for review and study:

> "The American farm system has remained a family enterprise for almost two centuries. Since the formation and implementation of Federal Estate Tax, the passing of a farmer's property to surviving family members has become an area of increasing concern and skyrocketing costs. Farm and ranch real property causes increased administrative cost which is quite peculiar to this agribusiness. The majority of our farmers and ranchers are cash poor, adding to the tax and administrative dilemma.
>
> "Questions such as 'How do I retire from farming without huge tax burdens?' are quite often asked of me. The sale of the family farm to a family member is one way to offer an older farmer his retirement. Leases on the land to a family member merely postpone estate transfer costs while allowing the land to inflate in

value, again increasing ultimate transfer costs. Gifts of land in a small family won't keep up with appreciation of the land retained. The transfer problem is very real and without good answers.

"The problem is complicated by no living alternative. A farmer must die in order to transfer his property to a surviving family member, or sell the property while alive. However, a preventative medicine type of approach is sorely needed.

"It is no harder to value a farmer's land before death than after death. Many would argue it is much easier to value a farm prior to the death of the farmer because the knowledge of the farmer can be employed.

"In many, if not most, areas of taxation, provisions exist recognizing an overpayment or prepayment of tax. Such a prepayment system would allow both young and old farmers a way to pass along property to heirs because estate tax would be prepaid. A young farmer could 'buy' his father's farm by setting up a fund with the IRS to prepay his father's estate tax on the farm property, and the young farmer's payments could be credited against income tax and credited for early payment by discounting the ultimate cost. An older farmer would be able to pay the IRS a sum equal to the discounted value of his ultimate estate tax, thereby transferring property to the survivor without current gift taxation or future estate taxation on that property. Costs would be known, the government would have an infusion of tax

> prior to the time they'd normally receive the tax funds and the farmer and the IRS would greatly reduce the administrative costs now associated with payment and collection of estate tax.
>
> "Such a prepayment arrangement would allow costs to be known and expenses for estate taxes be a part of the farmer's annual budget. It would allow farmers and ranchers to retire, knowing their farm or ranch was transferred to an heir without shrinkage or impairment. The transferor would also be able to impart years of experience to the heir, resulting in a lower expense operation. The IRS would be able to reduce current collection costs and court expenses, and would benefit by receiving a future tax liability today. Such a provision allows for simplication of a very complex and expensive death transfer system."

We hope Congress will make every effort to develop programs which will assist beginning farmers to establish themselves on family farms to assure a continued abundant and stable supply of food and fiber for our nation.

I believe the extended life span of our population raises some fundamental concerns in this area. Farmers are living and working longer, many of them managing their farms into their 70's or 80's. They are not bound by formal age-related retirement requirements. Many of them are anxious to continue active involvement in this life-long vocation.

If sons or daughters join in the family farm operation, they may find themselves in the role of "a cheap hired man" for much of their adult life before they move to the formal inheritance and management of the farm. In discussions at farm women's conferences, I find this has led to considerable emotional as well as economic strain within many farm families.

The capital required to move into full-time farming these days is prohibitive for most beginning farmers to acquire early in their work life. The National Farmers Union has supported for 10 years legislation that would establish a credit policy specifically directed to assist beginning farmers to acquire land and machinery under some supervision and reduced interest rates.

The Canadian province of Saskatchewan has developed an extremely successful program to serve their beginning farmers. A number of states have made efforts to develop state programs. Minnesota has successfully launched their family farm purchase program, which has demonstrated the concept but which has, I am told, not been able to assemble adequate capital resources to meet the needs and demands for more than a small percentage of deserving beginning farmers.

I believe this is an important part of the consideration of estate and gift tax policy that also must be of basic concern in the development of national legislation.

We support the adoption of S. Res. 126, which expresses the sense of the Senate that changes in the federal estate tax laws made by the Economic Recovery Tax Act of 1981 should not be modified. We believe it is important to keep the present legislation in place until long-time careful planning for alternatives can be developed.

NFIB National Federation
of Independent Business

The Guardian of Small Business

STATEMENT

SUBMITTED BY

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before: Senate Committee on Finance, Subcommittee on Estate and Gift Taxation

Subject: Estate Tax Issues

Date: June 27, 1983

Mr. Chairman:

On behalf of the 570,000 members of the National Federation of Independent Business (NFIB), we appreciate the opportunity to comment on estate tax issues. Senator Symms is to be applauded for holding hearings to highlight the importance of the estate tax provisions in the Economic Recovery Tax Act of 1981 (ERTA) to small business. The membership of NFIB is strongly united in supporting estate tax provisions of ERTA which are very necessary to the growth of small business.

The Economic Recovery Tax Act of 1981 made substantial changes to the estate and gift tax laws as they impact on small business. The changes enacted will result in dramatic reductions in the financial and paperwork burden imposed by these taxes on small

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business. Without exception, small business owners have supported these changes, and the membership of NFIB considered them to be among the highest goals of tax reform to be accomplished in 1981.

Senate Resolution 126, which expresses the sense of the Senate that the reduction in the Federal estate and gift tax scheduled to take place through 1986 should remain undisturbed, is fully supported by NFIB. Any freeze or reduction in scheduled estate tax decreases will be viewed as highly unfavorable to small business interests. To the typical small business owner, the estate tax is viewed as both a confiscatory tax which reduces the productivity of small business, and a tax which strikes at the heart of small business by jeopardizing the continuance of family owned businesses.

In the eyes of many who are involved in tax policy, the great concern that small business expresses over the estate tax appears blown out of proportion to reality, as it is their impression that only the wealthy are impacted by the estate tax. It is often true that perceptions do not square with reality, and this is certainly the case here, for small business is severely affected by the estate tax.

When the owner of a small business dies, the beneficiaries must raise the necessary cash to pay any Federal estate taxes. A curse of most small business owners is the consistent need to reinvest taxed business earnings back into their business. When the owner dies, there usually is insufficient cash available to pay the estate tax, often necessitating liquidation of the business. This is a tragedy, for in many cases the family has been a major factor in the success of the small business, even though the surviving family members may not be legal owners.

Exacerbating this situation has been inflation's impact on the value of farm land and small businesses in general. Prior to 1981, Federal estate tax liabilities were increasing dramatically, causing great concern among small business owners that their life's work would not continue. Only one form of protection was available, i.e. life insurance on the owner which would provide the necessary liquidity in case of death. Life insurance also drained cash, hurt productivity and prevented the business from growing. The wealthy owners of larger businesses do not have these problems. They are able to transfer wealth between generations by utilizing tax counsels who employ sophisticated tax planning to minimize or eliminate Federal estate taxes.

Small business concerns with the estate tax were substantially alleviated by the passage of ERTA. Current attempts to justify freezing the benefit phase-in are based on arguments of deficit reduction. However, Congress' primary concern in this case should be the cost to small business owners of protecting their business from a tax which exceeds the social benefit derived from the tax.

S. 1250 and S. 1251

The membership of NFIB is convinced that Federal estate taxation of small business makes little sense and. We therefore support S. 1250, which has as its goal the full repeal of estate taxes.

In the short term, S. 1251, which would ease the qualifications for electing installment payment of estate taxes for closely held businesses, would help to ease the liquidity problem of small businesses who become subject to the Federal estate tax. This proposal is a helpful short-term solution to the problems faced by small business.

Conclusion

The membership of NFIB strongly supports Senate Resolution 126, which expresses the sense of the Senate that the changes in the Federal estate tax laws made by ERTA should not be modified. The membership of NFIB also supports S. 1250 as a long-term goal of tax policy and S. 1251 as a short-term requirement for small business.

112T

NATIONAL FOREST PRODUCTS ASSOCIATION
1619 Massachusetts Avenue, N. W., Washington, D. C. 20036

STATEMENT BY THE
NATIONAL FOREST PRODUCTS ASSOCIATION
AND THE
SOUTHERN FOREST PRODUCTS ASSOCIATION
FOR THE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
COMMITTEE ON FINANCE
UNITED STATES SENATE

July 1, 1983

The National Forest Products Association is a federated association that represents over 2,500 forest product companies and 32 regional and national forest industry associations on matters affecting the use and management of timberlands, the growth and harvest of timber, and the manufacture and utilization of forest products.

The Southern Forest Products Association is an organization of manufacturers with operations in Alabama, Arkansas, Florida, Georgia, Louisiana, Mississippi, North and South Carolina, Oklahoma, Tennessee, Texas, and Virginia. SFPA member mills account for three-fourths of the total southern pine lumber output and also produce quantities of softwood plywood and pulpwood.

Private nonindustrial landowners control 58 percent of the nation's commercial forest acreage and supply approximately 48 percent of the total harvest.

In the South, this group owns three of every four commerical forest acres and supplies two-thirds of the raw material for softwood lumber and plywood production and three-fourths of the pulpwood production. The dependency of the forest industry on the nonindustrial private sector will increase appreciably in the years ahead as the South becomes an even more important source of wood for the nation as a whole by the end of this century.

Unfortunately, the current rate of timber growth on the huge aggregate of nonindustrial private ownerships is less than the potential. Obviously, this problem must be resolved for the nation and the region to be able to meet its anticipated future responsibility as a supplier of forest products. One of the most important needs is a continuation of the improvement in tax incentives which encourage tree planting and the practice of forest management by private landowners.

While the federal estate tax has been a comparatively small source of revenue for the Federal Treasury -- some $6 billion a year -- it has, in many cases, had an extremely depressing effect on forest management motivations of the nonindustrial private owners.

Exorbitant estate taxes have forced many heirs to sell timber prematurely, to the detriment of both the land and themselves. Additionally, forced sale of the land itself to pay taxes is not uncommon.

High estate taxes also discourage current forest owners from improving and managing their lands, knowing both the land and timber may well have to be liquidated by their heirs to pay taxes. In many cases, land sold under these conditions is converted to non-timber use, thus reducing the timber supply base.

The first major constructive step in the direction of federal estate tax reform occurred in 1979 when Congress voted to repeal the carryover basis rule of estate taxation. If left untouched, this add-on to the 1976 tax bill would almost certainly have resulted in massive dissolution of family-held forestland.

Further improvements were achieved in the 1981 Economic Recovery Act, including an increase in credit from $275,000 for people dying this year to $600,000 for people dying after 1986. Also provided was a decrease in the maximum rate from 60 percent for people dying in 1983 to 50 percent for those dying after 1984.

Obviously this progress would be nullified if a proposal by Congressman Dan Rostenkowski, Chairman of the House Ways and Means Committee, should be approved by the Congress. Among other things, Rep. Rostenkowski suggests a freeze on statutory federal tax reductions scheduled to go into effect after this year. That, of course, would wipe out the hard-won gains in the estate tax area, much to the detriment of private forestry.

Progress, not retrogression, is needed in estate tax reduction. That is why both the National Forest Products Association and the Southern Forest Products Association wholeheartedly support Senate Resolution 126 introduced by Senator Wallop which opposes any changes in the estate tax provisions of the Economic Recovery Tax Act of 1981.

Beyond that, both Associations support current legislation calling for repeal of the estate tax on grounds that it is confiscatory and costs more money than it returns to the Federal Treasury. The Associations also support legislation which would repeal the generation-skipping transfer tax, and proposals for further reduction in the maximum rate as well as expansion of the range of estates eligible for special use evaluation.

The Associations are well aware that further reductions of the estate tax may not be feasible in a year when enormous federal budget deficits are projected. But, at the very least, the Congress should act to retain those reforms and improvements already enacted into law.

nmpf

national milk producers federation

1840 Wilson Blvd., Arlington, VA 22201
(703) 243-6111

Patrick B. Healy
Chief Executive Officer

The National Milk Producers Federation is a national farm commodity organization representing virtually all of the dairy farmer cooperatives and their dairy farmer members who serve this nation by producing and marketing milk in every state in the Union.

Since its inception in 1916, the Federation has actively participated in the development of dairy programs which are a part of a total system of agricultural law and policy which can appropriately be termed a national food policy.

The policies of the Federation are determined by its membership on a basis that assures participation from across the nation. The policy positions expressed by NMPF are thus the only nationwide expression of dairy farmers and their cooperatives on national public policy.

Before the

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

of the COMMITTEE ON FINANCE

UNITED STATES SENATE

With regard to

Estate Tax Issues

July 8, 1983

Patrick B. Healy
Chief Executive Officer

The National Milk Producers Federation is the national farm commodity organization representing dairy cooperative marketing associations owned and operated by dairy farmers throughout the nation. Most of the nation's milk supply is marketed through the cooperative associations represented by the Federation. It is the only organization whose policy represents a national consensus of dairy farmers. As such it has long been interested in legislation, including that relating to estates and gifts, which directly affects the structure and effectiveness of dairy farms.

Your committee is to be commended for reviewing the status of estate and gift tax law at this time. While the present committee update can serve as a valuable background for serious program change consideration, hopefully in the next Congress, there are items which must be faced at the present time. The Federation is deeply concerned at any effort to freeze the estate tax exemption at its present level.

On June 5, 1981, we testified in support of increasing the estate tax exemption. At that time we showed that the value of the average commercial dairy farm--one with 50 to 60 milking cows operating 300 to 400 acres of land--approximated $600,000. Therefore, even with the $600,000 exemption any family dairy farm above this average faces the likelihood of having to pay estate taxes.

We have been deeply concerned about the impact of this tax on the ability to transfer family farm operations from one generation to the next. In our 1981 statement we pointed out the necessity of increasing the estate tax exemption. This need has not changed. The lack of liquid assets in family farm operations continues to make them vulnerable to being divided up if a substantive estate tax is imposed.

In our testimony at that time we urged the immediate adjustment to the $600,000 figure. This was not done; instead the $600,000 figure was reached by a phase-in over a period of years extending to 1987. While we were not happy with this protracted approach we recognized it as a proper step toward establishing a reasonable estate tax base.

Since adoption of the 1981 law the value of a commercial dairy operation has changed only slightly, but the change has been toward an increased value, in part because of inflation and in part because the average sized herd continued to increase in number.

A freeze on the estate tax exemption would cap it at $275,000. To do so is not to retain the status quo as some might think. Instead it is a step backward. It would perpetuate the problem we are attempting to have overcome--the jeopardizing of a family farm structure in order to pay estate taxes.

Senate Resolution 126 expresses the sense of the Senate that the changes in the estate tax exemption provided in the Economic Tax Recovery Act of 1981 proceed on schedule. We support this resolution and trust it will serve to deter those who have advocated a freeze by showing that the Senate is not so disposed.

Special use valuation--In our 1981 testimony we raised specific points about the means of determining the special use valuation which should be addressed. Permit me to quote from our June 5, 1981 statement. (For reference bill S. 395 was the estate tax vehicle being considered at that time.)

> "We feel, however, that S. 395 has failed to address one serious problem area relating to special use valuation. That is the mechanics of determining such value. Much of this stems from the need to determine comparative values in other properties. In one Wisconsin case the special use valuation could not be taken on a barn, because no other barns were rented separately nearby. The same estate almost lost its benefit on its land because of the reluctance of other farmers to divulge their leasing agreements.

> "Other problems have arisen, notably on share leasing and on rather strict interpretations of this provision of law by IRS.
>
> "It would therefore seem far more preferable to have the special use valuation determined on some appraisal basis of the farm. Such appraisal might be on a yield basis, which could then be converted to an agricultural value."

To overcome this type of problem others have urged a "safe-harbor" approach as an optional alternative. It would permit qualified property to be treated for estate purposes at 50 percent of its fair market value. We support this concept as an option. The determination under it can easily be made and would overcome some of the problems we cited in our 1981 testimony.

We also support proposals to change the law to permit an executor to change the method of determining the special use valuation of an estate through the filing of an amended return within the time permitted by the statute of limitations. To us there seems no logic to arbitrarily holding an estate to its original method of determining the tax without affording it the opportunity to change to others if it is prudent to do so.

In summary we therefore urge extending the estate tax exemption to the $600,000 total without any freeze being imposed. We also support any practical changes which will make the special use valuation the tool it is intended to be in determining agricultural estates.

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June 23, 1982

Honorable Steven Symms
452 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Symms:

We are aware of your concern for the problems of small businessmen and the difficulties created by the existing estate tax structure, as evidenced by your sponsorship of S.2479.

We strongly concur with the revisions made by this bill and share the view that the availability of the installment payment provision of Internal Revenue Code section 6166 should be expanded.

While S.2479 expands the availability of the installment payment provision by making certain exceptions to the "trade on business" requirement of section 6166, we believe that you should also take the opportunity to correct unjustifiable limitations imposed by the Internal Revenue Service on the meaning of the term "trade or business" for purposes of section 6166. In particular, we are concerned that the Service's position that a real estate rental business does not qualify for the installment payment provision imposes a severe and adverse effect upon the welfare of a great many American families. (A summary of the major points made in this letter is enclosed.)

As noted in the summary prepared by the staff of the Joint Committee on Taxation, the most detailed guidelines on what constitutes a trade or business under the installment payment provision are found in three 1975 revenue rulings (Revenue Rulings 75-365, 75-366, and 75-367).

As you know, section 6166 provides that if more than 35 percent of a decedent's gross estate consists of an interest in a closely held business, the executor may elect to pay the estate tax in up to ten annual installments. An interest in a closely held business is defined to include an interest as a proprietor in a "trade or business" carried on as a proprietorship, as well as an interest as a partner or as a stockholder in a closely held partnership or corporation carrying on a "trade or business."

Since the management of rental real estate generally constitutes a "trade or business" under other sections of the Code in which that term appears, it had always been generally assumed that the portion of an estate tax attributable to a decedent's ownership of such properties would be eligible for deferral under section 6166. See, for example, Saunders, "Trade or Business, Its Meaning Under the Internal Revenue Code," 1960 So. Calif. Tax Inst. 693 at pgs. 721-725 (1960). This belief was apparently shared by the Service itself, which in a 1966 ruling (Rev. Rul. 66-62, 1966-1 C.B. 72) gave as an example of a closely held business within the meaning of section 6166 the operation of an office building owned by the decedent. This long-standing policy was abruptly reversed by the three rulings mentioned above.

The thrust of these rulings is that an owner's management of rental property does not constitute a "trade or business" for purposes of section 6166. All of these rulings assert that Congress, in enacting section 6166, intended the term "trade or business" to have a much narrower meaning than it carried in all other sections of the Internal Revenue Code. For example, Rev. Rul. 75-367 describes a situation in which the decedent owned a small business corporation engaged in home construction, a sole proprietorship that developed the land and sold the homes, and a business office and warehouse shared with the corporation. The decedent also owned and rented eight houses purchased over a period of twelve years. The decedent collected the rents, made the mortgage payments and made the necessary repairs and maintenance on these homes. As can be seen from the attached memorandum, the decedent's activity with respect to these houses would clearly be sufficient to constitute a "trade or business" under all other sections of the Code in which that term is used. The ruling nevertheless concludes that the estate tax attributable to the decedent's ownership of these homes is not eligible for deferral under section 6166 on the ground that the decedent was not engaged in a "trade or business" with respect to these assets.

The rulings recognize that this position is inconsistent with the usual interpretation of "trade or business," although the Service is something less than candid in describing the extent of the departure. Each of the rulings contains the following statement:

> What amounts to a "trade or business carried on" within the meaning of the statutory language of section [6166(b)(1)] of the Code, ("an interest as a proprietor in a trade or business carried on as a proprietorship") should not be determined merely by reference to a broad definition of what "business" is or to a case-law definition of the term for purposes of some other section of the Code such as found in section 162, but should be found in keeping with the intent of the legisla-

> ture in enacting section 6166. Although the management of rental property by the owner may, for some purposes, be considered the conduct of business, in the case of a sole proprietorship, section 6166 was intended to apply only with respect to a business such as a manufacturing, mercantile, or service enterprise, as distinguished from management of investment assets.

We do not dispute the Service's contention that Congress did not intend section 6166 to apply to activities which constitute the mere "management of investment assets," as opposed to the conduct of a "trade or business." And we emphatically agree that Congress' intent should be the governing factor. The question at issue, however, is whether Congress intended to exclude the ownership of rental real estate from the benefits of section 6166. In resolving this question, the fact that the real estate activities of the decedents described in Revenue Rulings 75-365 and 75-367 would be considered to constitute a "trade or business" under all other sections of the Internal Revenue Code in which that term is used would certainly seem to merit some consideration.

A most fundamental rule of statutory construction is that a word or phrase is presumed to have the same meaning in one section of a statute that it has in another.[1]

The application of this rule is unusually appropriate in the case at hand. The term "trade or business" has a history which predates that of the Internal Revenue Code of 1954.[2] Indeed, in Whipple v. Commissioner, 373 U.S. 193, 83 S.Ct. 1168, 10 L.Ed. 2d 288, 11 AFTR 2d 1454 (1963), which involved section 23(k) of the Internal Revenue Code of 1939 (the predecessor of present I.R.C. section 166), it was possible for Justice White to state that the phrase "trade or business" was already "terminology familiar to the tax laws," when Congress "deliberately used" the term in drafting section 23(k) in 1942. When section 6166 was first introduced into the Code in 1958 (P.L. 85-866, section 206(a)), it had already been long established that, unlike the management of one's investment portfolio, the management of rental real estate constitutes a "trade or business".[3] It thus hardly seems likely that when Congress chose to use the term "trade or business" in I.R.C. section 6166, it was unaware of the fact that the management of real estate would be included within the accepted interpretation. It is equally unlikely that the issue did not occur to anyone since the management of rental property is certainly one of the most common and obvious types of closely held businesses in the United States.

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[1] Corpus Juris Segundum, "Statutes", sec. 316 at p. 553, citing two federal tax decisions by the Supreme Court, Helvering v. Stockholms Enskilada Bank, 293 U.S. 84, 55 S. Ct. 50, 79 L.Ed. 211, 14 AFTR 675, 676 (1934) (Sutherland, J.) and British-American Tobacco Co. v. Helvering, 293 U.S. 95, 55 S. Ct. 55, 79 L.Ed. 218, 14 AFTR 680 (1934), affirming, 69 F. 2d 528, 13 AFTR 724, 727 (2d Cir. 1934). ("The history of this taxation statute warrants the approval of construction which results in consistancy.") A closely related principle is that terms which have previously been used in similar or related statutes and which have been given a well defined meaning by the courts are presumed to have the same meaning in the statute subsequently enacted. C.J.S., op. cit. at pgs. 551-552. "The first and most elementary rule of construction is that it is first assumed that words and phrases of technical legislation are used in their technical meaning, if they have acquired one, and, otherwise, in their ordinary meaning." Maxwell on Interpretation of Statutes (11th ed. 1962) at p. 3.

[2] The term first appears in section 214(a)(1) of the Revenue Act of 1918, P.L. 65-254 (1919). This provision survives in substantially identical form as present I.R.C. section 162(a).

Although the Service repeatedly declares that Congress intended section 6166 to apply only to "manufacturing, mercantile and service enterprises", it offers no evidence to contradict the presumption that Congress intended the phrase "trade or business" to carry its usual meaning. Certainly no such evidence appears in the published legislative history. We have examined all the available Congressional documents relating to section 6166, particularly H.R. Rept. N. 2198, 85th Cong., 2d Sess. (1958) at pgs. 6-8.[4] It is clear from these documents that Congress's intent was to prevent the necessity for the sale or liquidation of a closely held business in order to obtain funds to pay the Federal estate tax. These documents provide no support whatever for the Service's narrow and unusual interpretation.[5]

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[3] See, e.g., George Jephson, 37 B.T.A. 1117 (1938) (predecessor section to I.R.C. section 1231); Leland Hazard, 7 T.C. 372 (1946) (under predecessor section to I.R.C. section 162(a)); Fackler v. Commissioner, 133 F.2d 509, 30 AFTR 932 (6th Cir. 1943) (predecessor section to I.R.C. section 1231); Anders I. Legreide, 23 T.C. 508 (1954) (predecessor section to I.R.C. section 172); Jahn Casimir Lewenhaupt, 20 T.C. 151 (1953), aff'd 221 F.2d 229 (9th Cir. 1955) (under predecessor section to I.R.C. section 871). Compare, Higgins v. Commissioner, 312 U.S. 212, 61 S. Ct. 475, 85 L.Ed. 783, 25 AFTR 1160 (1941) (holding that the management of one's own portfolio of securities, unlike the management of rental real estate, does not constitute a "trade or business").

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4 In addition to the legislative history accompanying P.L. 85-866, we have also examined the legislative history accompanying the amendments made to section 6166 by P.L. 94-455 (1976), P.L. 95-600 (1977), and P.L. 97-34 (1981).

5 The only "authority" cited in these rulings is Rev. Rul. 61-55, 1961-1 C.B. 713, in which the Service concluded, with absolutely no discussion, that the ownership of a royalty interest in an oil well did not constitute a "trade or business" under section 6166. This conclusion is totally consistent with the accepted interpretation of "trade or business" under other sections of the Code, and certainly does not suggest that the term "trade or business" has an unusual meaning in section 6166. We note that S. 2479 would treat royalty interests in oil and gas ventures as interests in closely held businesses regardless of whether such interests would generally be included in the term "trade or business".

Nor does the statute on its face provide any basis for concluding that it was not intended to apply to the management of rental property. Section 6166 is obviously intended to avoid the necessity of having to sell a family business to pay estate taxes or at least to insure that the liquidation can be carried out in an orderly way and at a fair price. See H.R. Rept. No. 2198, 85th Cong. 2d Sess. at pgs. 6-8. This provision complements I.R.C. section 6161 which was enacted at the same time as section 6166. I.R.C. section 6161(a) authorized the Service to extend the time for the payment of estate taxes for a period of up to ten years if such extension is needed to avoid "undue hardship" to the taxpayer.[6] Indeed, section 6166 can best be seen as a statutory presumption of hardship as to the portion of the estate tax attributable to the value of a closely held business.

In Revenue Ruling 75-365, which describes a situation where the decedent owned and managed two pieces of rental property, an office building and a parcel of farm land, it is suggested that no hardship would be imposed if the tax deferral provisions of section 6166 were inapplicable because the disposition of one of the income producing properties "would not affect the management of, or threaten the income from, the properties remaining." This would certainly not be true of all real estate businesses, but in any event it is difficult to see its relevance to section 6166. If the decedent had instead owned a grocery store and a gas station it would also be true that either of the properties could be sold without affecting the income from the other. Nevertheless, section 6166(c) expressly provides that the values of two or more totally unrelated businesses can be combined for the purpose of determining the percentage of the estate attributable to "an interest in a closely held business." This percentage, in turn, determines both eligibility for the section 6166 election, and the portion of the estate tax subject to deferral. It should also be noted that the Service's argument would not explain why section 6166 should not be available where the decedent's business consisted of the management of a single large office or apartment building.

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[6] See also, section 6163, "Extension of time for payment of estate tax on value of reversionary or remainder interest in property," also enacted by P.L. 85-866.

The Internal Revenue Service itself appears to have had second thoughts about the correctness of the 1975 rulings since recent private letter rulings of the Service have generally concluded that the management of rental real estate satisfies the "trade or business" requirement of section 6166. See, e.g., PLR 8145008, PLR 8205026. However, these private letter rulings purport to follow Rev.

Rul. 75-367 and distinguish themselves on the basis that the "amount of activity" of the decedent in Rev. Rul. 75-367 was insufficient to constitute a business enterprise. While we concur with the results reached in the private letter rulings, we do not believe that these results are consistent with Rev. Rul. 75-367.[7] The Service's willingness to distinguish Rev. Rul. 75-367 in private letter rulings with similar fact patterns highlights the inappropriateness of the conclusion reached in the 1975 revenue rulings. The lack of consistent standards in this area leaves taxpayers without proper guidance and at the mercy of case by case factual distinctions by the Service.

Other private letter rulings of the Internal Revenue Service have distinguished Rev. Rul. 75-365 on the basis that the decedent in Rev. Rul. 75-365 did not personally operate and maintain the rental properties but rather directed the maintenance of his properties by contract.[8] The Service apparently attributes services performed by an "agent" of the decedent (see PLR 8133022) or by employees supervised by the decedent (see PLR 8218072) to the decedent in order to satisfy this personal activity requirement. However, a decedent who operates and maintains his rental real property "by contract" (as in Rev. Rul. 75-365) is apparently not considered to be carrying on a "trade or business" for purposes of section 6166 regardless of the amount of services performed in operating and maintaining the rental property. This focus on the personal activities of the decedent is warranted by neither the statutory language of section 6166 nor any of the legislative history of this section of the Internal Revenue Code.[9] To promote an evenhanded and uniform interpretation of the term "trade or business", we suggest that your bill incorporate the amendment to section 6166 stated at the conclusion of this letter.

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[7] The decedent in PLR 8145008 owned and operated a 36-unit apartment house and did all the "maintenance, repairs to structure, fixtures and equipment, gardening, grounds maintenance, cleaning, painting, rent collecting, bookkeeping, tax return preparation, lease negotiations, evictions, and purchasing of equipment and supplies." The decedent in PLR 8205026 rented residential dwellings which he had peviously built and did "all the necessary maintenance and repair work" as well as collecting the rents. The activities of these decedents are comparable to those of the decedent in Rev. Rul. 75-367 who "collected the rents, made the mortgage payments and made the necessary repairs and maintenance" to the rental property.

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[8] The requirement that the decedent personally manage his rental properties is apparently imposed only in the case of a sole proprietorship. A decedent who is a shareholder in a corporation owning and operating rental property or a partner in a partnership owning and operating rental property need not be personally involved in the management of the property. See e.g., PLR 8050002, PLR 8136022.

[9] Of note is the requirement in I.R.C. §2032A(b)(1)(C)(ii) that in order for real property used as a farm or in a trade or business to qualify for special use valuation there be "material participation by the decedent or a member of the decedent's family in the operation of the farm or other business." If Congress intended that the decedent be personally involved in the management of a closely held business in order to qualify for installment payment of estate taxes, a similar provision would seemingly have been included in sectin 6166. The Service's unilateral imposition of such a requirement, without the support of statutory language or legislative history, is clearly a case of the Service substituting its own policies for those of Congress.

Most important of all, denying the benefits of section 6166 to the estates of decedents who are engaged in the business of managing rental property will impose a very serious hardship on a great many American families. As you know, commercial real estate is one of the least liquid of all possible investments. Even in the best of times a substantial piece of real property must be on the market for a considerable period before the fair market value can be realized. In addition, the real estate market is traditionally subject to cyclical swings, which in recent years have become increasingly severe. This factor is largely a function of the fact that real property is generally acquired with borrowed money. Furthermore, if properties must be sold off in order to raise the funds needed to pay estate taxes, it is unlikely that the decedent's family will subsequently be able to replace them without great difficulty. This difficulty results from the fact that the ability to obtain the kind of loan necessary to acquire a rental property will largely depend upon one's personal reputation as a successful operator of rental properties. Assuming that new loans can be obtained at all, it is more than likely that they will be available only at much higher rates of interest.

In short, we find nothing to justify the Service's rather belated assertion that Congress intended to deny the benefits of section 6166 to the families of taxpayers engaged in the business of owning and managing rental properties. Indeed, both logic and the available evidence so clearly indicate the contrary that one cannot help but suspect the sincerity of the Service's effort to ascertain that intent. While the Service's zeal in collecting revenues is to be commended, we do not believe this purpose is properly accomplished by substituting its own policies for those of Congress.

Unless the Service's present policy in regard to section 6166 can be reversed in a relatively informal manner, we would urge you, for the reasons stated above, to give serious consideration to including in S.2479 a simple provision to amend section 6166 in order to correct this error. It would be sufficient, for example, to add the following language to section 6166:

> For purposes of this section, the term "trade or business" includes those activities which would constitute a trade or business for purposes of section 162.

(Section 162 allows a deduction for ordinary and necessary expenses incurred in a "trade or business.")

We appreciate your thoughtful consideration of this matter. Please let us know if we can be of assistance to your staff in connection with this problem.

Sincerely yours,

Roberts & Holland

ROBERTS & HOLLAND

SUMMARY

The Ownership and Management of Rental Real Estate is a "Trade or Business" for Purposes of Section 6166

1. Three 1975 revenue rulings set forth the position of the Internal Revenue Service that a real estate rental business does not qualify as a "trade or business" for purposes of section 6166 of the Internal Revenue Code.

(a) Neither the statutory language of section 6166 nor the legislative history accompanying its enactment provides support for the Service's position that Congress intended to exclude the ownership of rental real estate from the benefits of section 6166.

(b) An overwhelming body of authority holds that the ownership and management of rental real estate constitutes a "trade or business" under numerous other sections of the Code in which that term appears.

(c) Recent private letter rulings and technical advice memoranda issued by the Service conclude that the operation of rental real estate does constitute a "trade or business" on facts similar to the 1975 Rulings. The lack of consistent standards leaves taxpayers without proper guidance and at the mercy of case by case factual distinctions by the Service.

2. There is no policy reason to deny the benefits of section 6166 to the estates of decedents who are engaged

in the business of owning and managing rental property. Indeed, denial will impose a very serious hardship on a great many American families.

(a) If properties must be sold in order to pay estate taxes, the decedent's family may be required to sell at distress prices and not realize the fair market value on the sale of the property.

(b) A forced sale would make it unlikely that the decedent's family will subsequently be able to replace these properties without great difficulty and without assuming new loans at very high rates of interest.

3. Section 6166 should be amended to provide that the term "trade or business" includes those activities which would constitute a trade or business for purposes of section 162.

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June 23, 1983

To: United States Senate
Committee on Finance
Subcommittee on Estate and Gift Taxation

From: John D. Iskrant, Esquire

Re: Possible change to eliminate the problems with integrating the State death tax provisions with the unlimited marital deduction, to insure that the results envisioned by the unlimited marital deduction will be achieved.

Gentlemen:

Thank you for the opportunity to present testimony today concerning possible revision of the federal estate tax law so that the purposes of the unlimited federal marital deduction can be achieved, after taking into account the imposition of state death taxes.

My name is John Iskrant, and I am a partner in the Philadelphia law firm of Schnader, Harrison, Segal & Lewis.

United States Senate
Committee on Finance
Subcommittee on Estate and Gift Taxation

I have been practicing law since 1968, and have specialized in estates work since 1970.

As you know, the Economic Recovery Tax Act of 1981 introduced an unlimited marital deduction for federal estate tax purposes. The apparent intent behind provision of an unlimited marital deduction is to impose no federal estate tax in a situation in which a spouse leaves all his or her property to a surviving spouse. This apparent intent is borne out by a review of the relevant legislative history. Nevertheless, imposition of state death taxes now thwarts this intent.

In Pennsylvania, a flat 6% tax is imposed on testamentary transfers from one spouse to another. (I say testamentary transfers because property held jointly by husband and wife, which does not pass by will, is exempt from the Pennsylvania death tax.) There is no current, serious proposal to eliminate this state tax on interspousal transfers.

To take a simple, dramatic example of the interplay between the state death tax and the federal marital deduction, if a husband had an estate of $100 million and a will leaving everything to his wife, there would be a $6 million Pennsylvania death tax imposed on the husband's estate. Under current law, that would result in a federal estate tax of $2.5 million, even after taking into consideration the unified credit amount and the state death tax credit. (The $2.5 million assumes a 1983 decedent; the comparable figure for a 1987 decedent is $2.1 million.)

As you know, the unified credit equivalent amount for persons dying in 1983 is $275,000. The 6% Pennsylvania death tax on property passing to a spouse causes any estate of $4.6 million or greater to incur a federal estate tax, even though all of the decedent's property passes to his surviving spouse. In 1987, when the unified credit equivalent amount is fully phased in to $600,000, the comparable figure will be $10 million.

The problem affects much smaller estates if the unified credit equivalent amount is not fully available to soak up the state death tax. For instance, if a decedent's will says "I give my entire estate to my wife," but the decedent also had convenience trust accounts for his children, which would be payable at his death to his children, the unified credit equivalent would be reduced by the amount of such accounts. Or, to take another common example, if a decedent's will gives pre-residuary bequests up to the unified credit equivalent amount, but everything else to his spouse, none of the unified credit amount would be available to soak up the Pennsylvania death tax. The result would be that any estate which exceeds the unified credit equivalent amount would generate a federal estate tax, even if the entire estate beyond the unified credit amount were left to the surviving spouse.

It might well be asked why Congress should consider this problem, since it is one caused entirely by the death tax systems of the various states. I think the clear answer is twofold.

First, the current system involves a "tax on tax," that is to say a federal estate tax being imposed exclusively on the amount of a state inheritance tax. This is anomalous, to say the least.

Second, at a time when less federal funds are flowing to the states, so that states are increasingly having to rely on their own taxing powers, it does not seem appropriate to penalize states for the taxes they impose. Many state taxes are deductible by individuals for federal income tax purposes, so that in effect the federal government is sharing part of the burden of those taxes. In the situation under discussion, however, not only are state death taxes not encouraged, but in effect they are themselves taxed. Instead of the state tax reducing a tax burden otherwise owing to the federal government, the very imposition of a state tax results in a federal tax being levied. This is not consonant with a policy of encouraging states to rely upon their own taxing powers.

In summary, legislation along the lines of that suggested is necessary to effectuate the principles behind the unlimited federal marital deduction instituted by the Economic Recovery Tax Act of 1981. Further, an amendment to the federal estate tax along the lines discussed would eliminate the anomalous "tax on tax" described above.

Thank you for your time and attention.

Respectfully submitted,

John D. Iskrant

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August 19, 1983

The Honorable Steven Symms
Chairman
Estate and Gift Tax Subcommittee
Committee on Finance
United States Senate
Dirksen S.O.B.
Washington, D. C. 20510

Re: S. 1180
Hearing-June 27, 1983
Statement for the Record

Dear Senator Symms:

Please allow me to take this opportunity to again express my thanks to you and Senators Wallop and Boren for your continuing support and co-sponsorship of S.1180. It is a bill designed to correct a gross inequity in the tax treatment of disclaimers.

As you may recall, I had the honor of testifying before your Subcommittee, on this very issue, in May 1982. A copy of my testimony from that hearing is attached and I ask that it be made a part of this statement and included in the printed record of this proceeding.

We did not request permission to again present oral testimony at this hearing because, quite frankly, we believed we had already stated our case as succinctly and as honestly as we possibly could and did not want to unduly expend the time and attention of the Subcommittee. Nevertheless after reviewing the testimony as presented by Mr. Woodward of the Treasury Department, we feel compelled to respond lest our silence be deemed acquiescence.

The facts of our case remain the same. Unfortunately, the unfairness of the IRS position also remains the same. The particular trust that affects our client was written nearly 50 years ago and provided our client with an extremely remote contingent interest. So remote was the chance of her receiving anything (and she was only 6 years old at the time) that she was not even informed of the trust until 1974 when she actually became entitled to receive the property. Rather than accept the property however, she immediately disclaimed. She did not accept any benefit from the trust and neither income nor principal was used in any way. The funds in the trust were not borrowed nor used as collateral.

Given these facts, we cannot allow to go unchallenged Treasury's testimony that this bill seeks to help a group of taxpayers who "knowingly and willingly took a position contrary to the Internal Revenue Service's interpretation of the gift tax statute. These taxpayers simply lost a calculated gamble ...." At best, this statement is presumptious and self-serving. There is no indication whatsoever, that when our client disclaimed in 1974, she knowingly took a position contrary to the Service's interpretation of the gift tax statute.

Moreover, the Treasury Department in its testimony, did not share with the Subcommittee that our clients disclaimer in 1974 was actually in accord with the IRS position taken in a private letter ruling issued in 1966.

As I said previously, our client disclaimed in 1974 because it was then, for the first time, that she became aware of the trust property and for the first time actually became entitled to it, although she disclaimed without ever accepting any part of the trust funds.

In 1974, the accepted principle of state law and the common interpretation of the 1954 regulation governing this issue was that a person did not have to disclaim until he or she actually became entitled to the property. Consequently our client acted not on a "calculated gamble," but on the accepted practice of the Estate and Gift Tax Bar at that time.

Treasury charges that we seek "retroactive private relief" and this may be true. But if the relief we seek is "retroactive," it is because Treasury, and not the taxpayer has changed its interpretation of the governing regulation. If the relief we seek is "private" it is because the injustice strikes only a small number of taxpayers similarly situated by the unique combination of circumstances of having had contingent interests in very old trusts and then disclaiming those interests. Relief should not be denied because the number of taxpayers injured is relatively small. The injustice is no less real because the injury is not more widespread.

However, relief should not be foreclosed even if our client acted with knowledge that the Service had a "contrary interpretation". As a matter of fact, in 1974, the highest court to consider this issue, the Court of Appeals for the 8th Circuit, in Keinath v. Comm. 480 F.2d57 (1973), held in favor of the taxpayer and against the "contrary interpretation of the Internal Revenue Service." If we are to attribute knowledge of the law to our client in 1974 then it may be said she acted in accordance with the only relevant court decision at that time. Also, if the IRS continued to hold its "contrary interpretation" after the Court of Appeals ruled in favor of the taxpayer, it is curious to note the IRS did not then request that decision to be appealed to the Supreme Court. Justice Blackmun, in his dissenting opinion in the Jewett* case, commented on this very point: "for reasons best known to it, the Government did not seek certiorari in that case [Keinath] and the decision stood unmolested by any opposing appellate court authority for over seven years."

In fact it was not until 1981 that the IRS asked the Supreme Court to review this issue. Consequently, to classify the actions of a taxpayer in 1974, who relied on the only court decision applicable -- a decision of the second highest court in the country and one which the IRS did not ask the Supreme Court to review -- to classify these actions as "a calculated gamble" is patently unfair and bordering on the disingenuous.

One wonders at the "calculated gambles" that all of us must be taking today in following court decisions or long standing common law, lest the IRS change its collective thinking at some point in the future and make that change retroactive.

Gentlemen, we sincerely believe that there has been an injustice in the administration of these tax laws. It could not have been the intent of Congress to penalize taxpayers who acted in accordance with generally accepted principles of tax law and then to deny them the opportunity to conform to a change in the government's interpretation of those tax laws. Because this result could not have been your intent, we believe it is right and proper that we ask you -- the Congress -- for relief.

*Jewett v. Commissioner 102. U.S. 1082 (1982)

Thank you for your time and attention and we sincerely appreciate your efforts on our behalf.

Respectfully submitted,

James C. Heinhold

James C. Heinhold

lp

cc: The [redacted]
The Honorable David Boren
The Honorable Malcolm Wallop
The Honorable Charles Grassley

COMMENTS

of the

TAX LAW ACTION GROUP

Jointly Sponsored by the

AMERICAN NEWSPAPER PUBLISHERS ASSOCIATION

and the

NATIONAL NEWSPAPER ASSOCIATION

Before the

Subcommittee on Estate and Gift Taxation
Committee on Finance
United States Senate

on

Estate Tax Issues Including
S 1250
S 1251
S 1252
S Res. 126

Submitted for the hearing record of
June 27, 1983

The newspaper Tax Law Action Group is composed of independent family-owned newspaper publishers interested in assuring that federal estate tax burdens do not force the sale of family owned businesses.

The Action Group is jointly supported by the American Newspaper Publishers Association and the National Newspaper Association. ANPA is a trade association representing nearly 1,400 member newspapers which account for more than 90 percent of U.S. daily and Sunday circulation and which also includes many non-daily newspapers. NNA is a trade association representing some 500 daily and 5,000 weekly newspapers nationwide and is the oldest national press association in the nation.

In 1978, both ANPA and NNA formed separate task forces to study federal estate tax laws and their effects on family-owned businesses. Both found the federal estate tax laws biased against continued family ownership of newspapers and other businesses. Both also found themselves unwilling to seek a newspaper-only remedy. Each recommended to their respective association boards of directors that the organizations neither support nor oppose special interest newspaper legislation to deal with estate tax burdens on family-owned newspapers; but both urged reform of federal estate tax laws as they affect all family-owned businesses.

The Tax Law Action Group consequently was formed to seek federal estate tax reform. Since 1979 some progress has been made, especially in 1981, but a study prepared in 1982 for the Small Business Administration concluded:

> "... tax laws are a primary cause of mergers in the newspaper industry. ... These results have important policy implications. A democratic society depends on a diverse forum for the creation, assimilation, and dissemination of ideas and information. Corporate acquisitions of daily newspapers, weeklies, and cable television franchises continue. If such merger activity is encouraged by tax laws which appear to have little or no economic justification, appropriate

> government agencies should consider remedial policies. ... Estate taxes make it impossible for most families to retain ownership from generation to generation."

(Rand Corporation, "Newspaper Groups: Economies of Scale, Tax Laws and Merger Incentives," Report No. R-2878-SBA at pp. ix and 84.)

The newspaper Tax Law Action Group believes that the estate tax laws should not affect a decision regarding sale. Further, it believes that preserving individual and family ownership of businesses will help increase the productivity, competition and diversity of the nation's economy; and in terms of family-owned newspapers, First Amendment interest in a diverse marketplace of ideas.

The Economic Recovery Tax Act (PL 97-34) included a number of constructive changes in federal estate tax law. The subcommittee is familiar with these improvements, but the changes do not solve the very significant liquidity problems faced by many newspapers and other family-owned businesses upon the death of a owner.

The problem is especially difficult for newspapers and other business properties where there is a large disparity between market value and annual earnings. A common situation was reported in The Wall Street Journal of Aug. 19, 1981, in an article by Daniel Machalaba. The Salisbury (N.C.) Post, a daily newspaper with 24,700 circulation, was reported to have earned $400,000 in the previous year on revenue of nearly $4 million -- from a business property with an asset value of $3 million, yet a market value of around $20 million. The federal estate tax on $20 million, even under the new law which is not fully effective until 1987, is some $9.8 million -- a figure 24.5 times the Post's $400,000 annual earnings.

Earlier this year, the Santa Monica (Calif.) Evening Outlook was sold after 107 years of family ownership. The publisher, C. Deane Funk, 58, said that large estate taxes which would be owed upon the death of his mother, who is a major owner, was one of the primary reasons for the sale.

It is not possible to survey and quantify the estate tax challenge facing all family owners in the newspaper business, or in businesses generally. But we are convinced that estate taxes continue to force sales of family-owned businesses -- especially those businesses with high valuations and little liquidity. We believe many non-newspaper businesses face this challenge.

Family business owners do not seek to avoid their fair share of tax, but federal estate tax laws should not force sales of independent businesses in order to pay those taxes.

We support four bills before the subcommittee today as constructive contributions toward enabling family-business owners to deal with those challenges.

S Res. 126 -- We support this "sense of the Senate" resolution that changes in the federal estate tax laws made by the Economic Recovery Tax Act of 1981 should not be modified.

As you know, the estate tax rate changes enacted in 1981 do not take full effect until 1987. We mentioned this earlier in these comments where we cited the example of The Salisbury (N.C.) Post. When a 25,000 circulation daily newspaper is valued at $20 million, and the estate taxes reach $9.8 million -- a figure 24.5 times the business' annual $400,000 after-tax earnings -- the need is for even more help. Repeal back to a tax of $13 million, or a "freeze" which leaves the tax at $11.4 million, are backward steps. Because the tax must be paid in cash and not in business values, high taxes based on market value forces sale of the business.

S 1251 -- The newspaper Tax Law Action Group supports the provisions of this bill which would conform the Sec. 6166 shareholder test for eligibility for extended time payments to the Subchapter S shareholder test which Congress raised last year to 35. Both tests originally were designed to serve as a definition for smaller businesses eligible to use those tax provisions. Both tests originally were the same (10) and both concurrently were raised to 15 in 1976.

When Congress raised the Subchapter S test to 35 in 1982 and conformed it to small business provisions of securities law (see S. Rpt. No. 97-640, 97th Cong., 2d sess. 7, reprinted in 1982 U.S. Code Cong. & Ad. News 3259), it did not change the Sec. 6166 estate tax provision. This is not surprising since the 1982 legislation, the Subchapter S Revision Act, did not concern estate tax revisions.

The purpose of Sec. 6166 is to avoid forced sales of smaller businesses which face liquidity problems in meeting estate taxes. Sec. 6166 already embodies a reasonable liquidity test. Extended time payments of estate taxes are now allowed for estates with 35 percent or more of their assets tied up in the business, if one of two additional tests is met. Either the assets in the business must constitute at least 20 percent of the business, or the business must have 15 or fewer shareholders.

The Action Group knows that numerous smaller businesses that have survived several generations of family ownership now have increased their number of shareholders, frequently to more than 15. This is due to children and grandchildren receiving small amounts of stock from an original stockholder.

It was for this reason that the shareholder test for both Subchapter S and Sec. 6166 were raised from 10 to 15 in 1976, and it is for this reason that Sec. 6166 should continue to track Subchapter S.

The policy considerations of whether a business of 35 shareholders or less is qualified to use Subchapter S applies with equal force to the question of whether a business of 35 shareholders or less is qualified for Sec. 6166 extended time payments. Both involve defining smaller businesses, and both serve to encourage the continuation of smaller businesses by easing the burden of complying with tax provisions that have been designed for larger corporations. If anything, these policy considerations are even more justified in the Sec. 6166 situation because under Subchapter S, a smaller business avoids paying corporate income tax, while under Sec. 6166 the full estate tax is paid.

There are many family business owners today who cannot qualify for Sec. 6166 estate tax treatment, not because they are sufficiently liquid to meet their estate tax obligations, but simply because the business now has too many shareholders.

The Tax Law Action Group strongly supports conforming the shareholder test in Sec. 6166 with that now in use for Subchapter S election. In fact, we would welcome legislation liberalizing the shareholder test even further.

S 1252 -- We also support repeal of the generation skipping transfer tax. This law, enacted in 1976, will soon begin to have a significant impact upon estates. It introduces undue complexity into the tax laws with no comparable benefits for society. The tax laws should maintain a large measure of continuity so that business economic planning can be grounded in sound judgment.

When ANPA's Tax Law Task Force made its 1978 study of federal estate tax laws, it found that the tax on generation-skipping transfers "could have an adverse impact on the ability of a family to retain a closely-held business." Although funds from Sec. 303 redemptions could be used to pay this tax, it said, such redemptions must take place within a relatively short, specified time after the taxpayer's death. It recommended that Sec. 6166 be expanded to apply to the new generation-skipping transfer tax. While this recommendation merits consideration now, repeal of the generation-skipping provisions would be even more wise, in our opinion. At a time when estate taxes should be made less burdensome, it seems a mistake for additional tax complexities to become effective.

S 1250 -- Repeal of estate and gift taxes, as S 1250 would do, eliminates the problem outlined early in these comments. We understand that estate and gift taxes provide only between one and two percent of the federal revenue. Yet, an M.I.T. study entitled, "The Job Generation Process," conducted in 1979 by David L. Birch under an Economic Development Administration grant, found that about 60 percent of jobs generated due to business expansion "are produced by independent, free-standing entrepreneurs." If this is so, the detriment caused by federal estate tax laws limiting U.S. economic growth may outweigh the benefit of the revenues those taxes produce.

It is also true that estate tax laws are tending to divorce ownership from control in many family business situations. In the face of estate taxes which threaten demise of the business, owners are establishing trusts and other mechanisms which have the effect of reducing or eliminating control and responsibility normally passing to family members. The resulting control of businesses by corporate or other trustees may serve to diminish the diversity of ideas and information important to the community.

* * *

We would like to suggest one additional consideration as this subcommittee considers the effect of estate taxes upon family-owned businesses. This suggestion is contained in S 594, introduced by Sens. Durenberger (R-Minn.), Boren (D-Okla.) and Thurmond (R-S.C.).

When a business, or an individual, forsees the need to make a large expenditure, the normal planning mechanism is to save funds with which to meet -- or partially meet -- the expenditure.

If a newspaper for example realized that it would need to purchase a new press within the next ten years, it would be able to set funds aside to do so. The Internal Revenue Service would consider this a "reasonable business need" and even if the accumulated funds exceeded the $250,000 limit on "excess" business accumulations under Sec. 532, no accumulations "penalty" tax would be imposed.

Unfortunately, family-business owners may not (without incurring a substantial penalty) accumulate funds in advance to redeem a decedent's stock to provide liquidity for the estate. IRS does not recognize this as a "reasonable business need" and thus would tax the "excess" accumulations annually at up to 38.5 percent. Consequently, no amount of funds large enough to provide for the large estate taxes incurred in many family-business situations can be accumulated. Provisions of Sec. 303 for redemption of stock to pay estate taxes of a deceased owner are of no value if the business has insufficient funds with which to redeem the stock in the estate.

We believe that Congress should enact legislation which recognizes retention of a family-owned business within the family as a "reasonable need" of such a business. Accumulated funds would come from after-tax business income and would be included in valuations for estate tax purposes. Therefore these funds would bear a fair share of federal taxation.

S 594 would do this. It would also conform the Sec. 6166 shareholder test to 35, as would S 1251 currently before the subcommittee.

We hope this subcommittee soon will look favorably upon S 594, and we would be pleased to discuss aspects of that legislation with the subcommittee at a later date.

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June 15, 1983

Roderick A. DeArment, Chief Counsel
Committee on Finance
Room SD-221
Dirksen Senate Office Building
Washington, D. C. 20510

Dear Sir:

It is my understanding the Subcommittee on Estate and Gift Taxation of the Senate Committee on Finance will meet on June 27, 1983 in Room SD-215 of the Dirksen Senate Office Building to discuss estate and gift tax legislation introduced in the Senate, and that the Subcommittee would appreciate suggestions on estate tax reform measures.

It is good that the 1981 Economic Recovery Tax Act has provisions allowing post-death exchange of property selected for special use valuation without causing recapture of the tax saved by special use valuation.

It is also good that now under Section 6166 regulations for installment payment of federal estate tax portions of an interest representing less than 50%, rather than 35%, of the value of the decedent's interest in a closely held business may be disposed of and/or withdrawn before payment of the balance of the estate taxes attributable to the interest will be accelerated. For this purpose, dispositions and withdrawals are aggregated. We also welcomed the provision that now the transfer of the decedent's interest in a closely held business upon the death of the original heir, or upon the death of any subsequent transferee receiving the interest as a result of the prior transferor's death, will not cause acceleration of taxes if each subsequent transferee is a family member (within the meaning of Code Sec. 267(c)(4)) of his transferor.

However, further liberalization of the regulations under Section 6166 installment payment of federal estate taxes are needed. One change I feel is needed that the heirs be allowed to exchange between themselves their interests in farms inherited without the value of their interests in such exchanges being included in the amount of decedent's interest in a closely held business disposed of and/or withdrawn before payment of the balance of the estate taxes attributable to the interest will be accelerated.

For example, in an estate a brother and sister inherit several farms together, each owning an undivided one-half interest in each farm. As you can readily understand, rather than owning the farms together for 15 years many persons in this situation would much prefer to exchange between themselves their interests in the farms inherited so that each heir would wholly own one or more farms and be able to make the decisions as to what crops should be planted, amount and kind of fertilizer and chemicals to be used, amount to be spent on repairs, etc., without having to consult the other heir.

Roderick A. DeArment, Chief Counsel
Committee on Finance
June 15, 1983

The regulations under Section 6166 should clearly allow the heirs to exchange their interests between themselves in farms inherited without such exchange being considered as property disposed of and without including the value of the property exchanged in arriving at the percent of property sold or disposed of in determining whether or not there is an acceleration of payment of the estate tax under Section 6166. Inasmuch as the regulations do not allow for undistributed income during the time payments of principal are being paid in installments under Section 6166, and the income when distributed is considered as a part of the property disposed of in arriving at a determination as to whether or not less than 50% of the property has been disposed of and whether or not the payment of tax is to be accelerated, and such property as crops on hand at date of death, which would naturally be disposed of within 15 years, are included in the disposition when sold in arriving at the percent of property disposed of, very little, if any, real estate could be exchanged by the heirs and stay under a 50% disposition of the property if the value of the real estate exchanged is included as property disposed of. As long as the real estate stays in the family, we feel the intent of the law to allow the family to keep the farms has been met, and it should not make any difference whether the brother and sister who inherit the farms continue to each own an undivided one-half interest in each farm, or whether they exchange interests between themselves and the brother owns Farm A, the sister owns Farm B, and they own Farm C together.

If the regulations under Section 6166 are liberalized to allow such an exchange of interests in real estate among family members without including the value of such interests as a disposition or sale in determining whether or not there should be acceleration of payment of the tax, we ask that such regulations be made retroactive to include property of decedents who died in 1982.

It would be appreciated if you would present this suggestion to the Subcommittee for its consideration.

Thank you.

Very truly yours,

E. R. Tipton

E. R. Tipton

ERT:vi

cc: The Honorable Jim Leach
House of Representatives
1514 Longworth House Office Bldg.
Washington, D. C. 20515

Statement of
K. MARTIN WORTHY
on S. 1983
before the
Subcommittee on Estate & Gift Taxation
of the Committee on Finance
United States Senate
May 27, 1982

My name is K. Martin Worthy. I am a lawyer in the firm of Hamel, Park, McCabe & Saunders in Washington, D.C. and have practiced tax law for more than 30 years.

I am here today to testify in support of S. 1983, which would amend section 2518 of the Internal Revenue Code of 1954 relating to disclaimers. The amendment relates to disclaimers of interests created before 1958, which are now governed only by case law and regulation.

I represent the Estate of Mrs. Helen Wodell Halbach, who died while a resident of New Jersey in 1972. Mrs. Halbach's father died in 1937, and by his will established a trust with the income to be paid to Mrs. Halbach's mother for life, with the remainder to be divided equally between Mrs. Halbach and her sister in the event of their survival of their mother. Thus, Mrs. Halbach's interest was wholly contingent and would not vest or become possessory in any sense until after her mother's death.

Mrs. Halbach's mother died on April 14, 1970, and Mrs. Halbach, four days later, executed a document in which she irrevocably renounced and disclaimed all her right, title and interest in the one-half share of the trust to which she would otherwise have been entitled. The bank administering the trust thereupon brought an action in the New Jersey courts to determine the effect of the disclaimer, and the Chancery court of New Jersey, in a carefully developed opinion published at 274 Atlantic 2d 614, held in late 1970 that the disclaimer, having been executed promptly after the death of the life tenant, was effective to prevent any passage of title to Mrs. Halbach. The Court thus required distribution of the half interest in the trust to which Mrs. Halbach would otherwise would have been entitled just as if Mrs. Halbach had not survived. The Court significantly noted not only that this was the accepted law of New Jersey, but also that the Court had been unable to turn up any rulings in any state that to be effective a remainderman's renunciation must occur within a reasonable time after learning that a remainder interest has been created--rather than a reasonable time after termination of the life interest.

As we will demonstrate in a moment, Mrs. Halbach had no reason to believe, when she executed her disclaimer in 1970, that she had in any way made a transfer of property subject to gift tax. However, by reason of the Supreme Court's decision earlier this year in Jewett v. Commissioner and the failure of Congress in enacting section 2518 to deal specifically with disclaimers of interests created before 1976, Mrs. Halbach's estate is being threatened with a gift tax on the value of the interest in the trust which she disclaimed in 1970 just as if she had accepted it and then later voluntarily transferred it to persons of her own choosing.

It has been accepted for nearly fifty years that a disclaimer or renunciation refusing to accept a gift or transfer by will, is not itself a transfer subject to gift or estate tax if the disclaimer is valid and properly made. Although until 1976 the Code contained no provisions governing the gift tax effect of disclaimers, in 1958 the Treasury published a regulation recognizing this court-established principle.

Before the 1958 regulation the courts of appeals had made it clear that a disclaimer which was valid and effective under state law did not result in a taxable gift. Although there was some variance in state disclaimer statutes and some states had no disclaimer statutes at all, it ~~was~~ clear from the authorities (such as Page on Wills) that as a general rule a disclaimer of an interest was valid under state law if it was unequivocal, made without prior acceptance, and made within a reasonable time. Furthermore--just as later held by the New

Jersey court in connection with Mrs. Halbach's disclaimer--in the case of an interest which did not take effect in immediate possession, a disclaimer did not have to be made before the termination of the preceding interest to meet the "reasonable time" requirement.

In the *Jewett* case, however, the Supreme Court last February held that under the 1958 regulation a disclaimer after 1958 of an interest created before section 2518 of the Code was enacted in 1976, will be recognized as free from gift tax only if the disclaimer is made shortly after the initial transfer from which the interest sought to be disclaimed eventually emerged. Under this interpretation future interests must have been disclaimed soon after their creation, no matter how unlikely or contingent the possibility that anything would ever be received. Since this is clearly contrary to the accepted law before 1958 and contrary to what many justifiably understood the law still to be in the period even after the regulation was promulgated in 1958 until well after Mrs. Halbach executed her disclaimer in 1970, the Supreme Court's decision is very unfair to holders of interests created before 1958, who had no reason to disclaim before that time and never had an opportunity to disclaim without gift tax--even "within a reasonable time"--after the regulation was promulgated.

The 1958 regulation--which is still in effect today as to pre-1976 disclaimers--provides that where local law

> "gives a beneficiary ... a right to completely and unqualifiedly refuse to accept ownership of property transferred from a decedent ..., a refusal to accept ownership does not constitute the making of a gift if the refusal is made within a reasonable time after knowledge of the existence of the transfer."

The regulation goes on that

> "the refusal must be unequivocable and effective under the local law."

This language differs significantly from an earlier published proposed regulation which would have required that a disclaimer be made "within a reasonable time after knowledge of the existence of the _interest_," rather than after knowledge of the existence of the "_transfer_." Certainly, it was reasonable to assume that the Treasury intended that to make an effective disclaimer without gift tax, the holder of a contingent remainder would have a reasonable time after his interest became present and possessory by transfer of the property to him, instead of merely a reasonable time after the creation of the interest as would have been required by the earlier draft.

The Supreme Court in _Jewett_ did not accept this interpretation of the final 1958 regulation. It referred instead to a memorandum circulated internally within the Treasury and not published until _1981_, which indicated, without any mention of contingent remainders, that changes in language which were made in the final regulation were intended simply to make clear that the effectiveness of a disclaimer turned on state law in all circumstances and not upon certain inflexible rules in the original draft. In any event, even if the purpose of the change in language was not the purpose suggested by comparison of the draft with the final regulation, this purposewould not have been apparent to holders of contingent interests at the time, since the Treasury memorandum was not made public until 1981. And if the change in language was intended to make clear the overriding importance of state law, this would necessarily mean that the law applicable in New Jersey (and most if not all states), that in the case of an interest which did not take effect in immediate possession, a disclaimer did not have to be made until a "reasonable time" after the termination of the preceding interest, would apply to disclaimants such as that by Mrs. Halbach.

It has now been admitted by counsel for the government that there is no evidence before litigation in the Keinath case in the Tax Court in 1972, that the Internal Revenue Service publicly took the position that the 1958 regulation required the holder of a future interest to disclaim shortly after the interest was created rather than after the termination of the preceding interest. That is two years after the renunciation by Mrs. Halbach.

It now further appears that despite an assertion by the Supreme Court that this had been the consistent interpretation of the 1958 regulation by the Commissioner over the subsequent years, it is in fact inconsistent with the Service's own position in a private letter ruling (6612201590A) dated December 20, 1966, and only recently released to the public. In that ruling the Service specifically held that a taxpayer's proposed disclaimer of a contingent interest in one-fourth of the income of a trust created 33 years earlier would not be a taxable gift. The Service ruled that if the renunciation was executed "within a 'reasonable time' from the time that she first received notice of her right to the additional income interest," by reason of a court decision that the income interest had vested in her because of her survivorship of two of her siblings, the requirements of the 1958 regulation would be satisfied. Because the taxpayer already held another income interest in the same trust, she had obviously long been aware of the creation of the trust 33 years earlier and of her contingent survivorship rights. In fact, after going back as far as 1954, the first ruling, public or private, I was able to find which requires disclaimer of a future interest before the preceding life tenant's death was not until 1978 -- five years after such position had been specifically rejected by the Eighth Circuit Court of Appeals in the Keinath case.

Under the Supreme Court's interpretation, the IRS, by promulgating the 1958 regulation, suddenly changed the rules in the middle of the game for a taxpayer owning a contingent interest created before 1958 without any opportunity ever to make a tax-free disclaimer thereafter. S. 1983 would correct the unfair effect of Jewett on holders of pre-1958 future interests by providing a grace period for disclaimer of such interests, and I strongly urge its enactment.

I would like the privilege of filing for the record a more complete technical analysis which I have here discussing in detail all of the authorities to which I have referred.

Thank you very much for this chance to present my views, and I will be glad to answer your questions.

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June 1, 1983

Committee on Finance
Room 221
Dirksen Senate Office Building
Washington, D.C. 20510

Re: S. 1251

Gentlemen:

The purpose of this letter is to comment on one aspect of the proposed Section 6166 Technical Revision Act of 1983.

Under the present effective date provision, the declaratory judgment procedure would not be available to an estate with an actual controversy as to eligibility for the extension provided by Section 6166 if the decedent died prior to January 1, 1983.

Our firm currently is acting as special tax counsel to the estate of a decedent who died prior to January 1, 1983. In connection with the pending Federal estate tax audit, it appears that a settlement may be reached on all issues of valuation. However, it is quite possible that there will be a dispute as to whether the estate is eligible for the extension provided by Section 6166. In our view, it would seem desirable for this estate to be entitled to pursue a declaratory judgment on this issue once all available administrative remedies have been exhausted. However, under the present effective date provision in the Bill, it is clear that the estate could not bring such an action.

We fail to see a reasonable basis for distinguishing between the foregoing situation and one where there is a controversy as to acceleration, with respect to which the effective date provision is somewhat more liberal (making the new procedure available if the disposition in question was made after December 31, 1982).

The present need for the declaratory judgment procedure is highlighted by the absence of any practical judicial review of a negative determination by the Internal Revenue Service on this issue. It is obvious that a refund action is not a viable alternative for an estate claiming eligibility for deferral under Section 6166.

It would seem more in keeping with the purpose of the new declaratory judgment provision for it to be generally available with respect to all controversies under Section 6166 arising after December 31, 1982, regardless of the date of death of the decedent or date of disposition of any estate assets.

Very truly yours,

YOUNG, KAPLAN, ZIEGLER & ZISSELMAN

By
A Partner

ZS:lt